The Investment Risks of Regime Shifts

Last month, like so many others, I scanned a 21st century tool, Twitter, to see if 18th century rules devised to transfer power from one US President to another would hold. They did, despite the fact that President Trump, with the enthusiastic backing of almost half of those who voted, sought to subvert them. The worst-case scenarios of election violence failed to materialize but the fear was real. After the election, stocks rallied in relief.

For investors, this episode serves as a reminder of a profound truth. The biggest risk is less a market gyration, these normally smooth out over time, and more a disruptive break in the existing order, from which investors may never recover. Wealth is lost permanently. However, in a dynamic economy existing order is *always* under strain, it's a question of degree.

The flux in wealth is what makes investing both so interesting and treacherous. As a global macro investor, when I build a portfolio, I am indifferent to national borders. My goal is to assemble a return stream to get the highest return for the risk I endure.

In doing so, I am mindful of the historic record. Yesterday's hegemon, like Portugal's colonization of Macau, is today's has been and vice versa. Germany is now considered a paragon of stability but witnessed both hyper-inflation and a break-down in order less than a century ago. While the US has the oldest constitution still in force, 238 years isn't that long. The average length of a Chinese dynasty over the last 1000 years is about 242 years.

In regime shifts currencies can implode either due to capital flight (many emerging market crises), printing (Weimar Germany) or capital controls (Soviet Union and China). Capital markets close, sometimes for decades. The Russian stock market closed after 1917, China's in 1949 and European markets often were suspended trading during their wars.

Yes, you can lose plenty of money without a regime shift, like the 1929 US stock market crash. Stocks fell roughly 90%. Yet, if the system remains intact, the markets will often come back to equilibrium as policy makers are *forced* to address the shocks that knocked markets out of equilibrium. In the case of the Great Depression, President Roosevelt needed to take the then almost unthinkable step of abandoning the gold standard. It’s also true that some regime shifts can be positive for investors, like the collapse of the Soviet Union, which presaged an opening of global capital markets.

Government structures often break when a protracted, broad decline in living standards is met with inappropriate policy. Given shifting technologies, living standards in certain sectors are always in decline, Detroit versus Silicon Valley. It’s a question of how big the dying sectors are relative to the rising. These disruptive shifts are tied to the very thing that has increases living standards: productivity.

Productivity fuels income growth; economic growth, or spending, is composed of both income and borrowing. Because the economy is always in motion, rules regulating the economy need to keep up, a challenging administrative ballet.

The question raised on election night and during the entire Trump Presidency was whether it was now the US’s turn to experience a fundamental break in rules. A number of pressures motivated Trump supporters, disproportionately rural men with a high school education. One consistent with other periods of institutional breakdown: flat real wages among the lowest quintile income groups *for decades*. This was in part caused by a shift in technology that created enormous profits in other parts of the economy, reflected in the performance of US technology stocks. An added twist with this technology shift—it changed media to an extent that it altered how citizens perceive reality, precisely how is a conversation for another day.

Going forward, both China and the US have significant economic strengths and substantial challenges that will test their models. Both countries are virtually alone among global economies in that they are large, diversified, mostly internally driven, a structural advantage. Most countries lack this dynamism. China and the US also face diminished competitiveness and high levels of both income inequality and debt.

Their governing models, open versus closed, are obviously different. Neither system is entirely open nor closed, but on a spectrum the US system is more open and the Chinese system more closed. In the West, debates about the merits of either approach go back to at least ancient Greece, where the “open” Athens fought a “closed” Sparta.

An open system holds the individual responsible for navigating an ever-shifting economic landscape. This process is chaotic and flexible. A closed system puts responsibility on a self-selected group of administrators to make appropriate decisions. The system is often (but not always) less chaotic and heightens dependence on the top. By putting limits on the executive, an open system precludes the transformative change

China has benefitted from in the last forty years. It also reduces the odds of (but does not prevent) a policy error like the Cultural Revolution.

In the short term, the risks of a more disruptive US institutional break have diminished though the underlying causes of the tension persist. President-elect Biden is a centrist. I am maintaining a long exposure in the US and, given the opening of Chinese capital markets and the likelihood of less bi-lateral conflict, hold the highest exposure to Chinese assets I have ever held. At the same time, I am mindful about the structural weaknesses in both systems and scanning for early signs of trouble. Both China and the US have descended into Civil War in the past. For a few days, the US seemed perilously close to starting down that path.

The Investment Risks of Regime Shifts

This edition is a "two-for," a podcast and investment perspective. If you want the asset allocation that goes with this investment perspective, email me and I'll share it. Also, if you like my book *Raising a Thief,* post a review on Amazon or tell a friend. If you like the podcast *Things I Didn't Learn in School,* post a review on Apple Podcast. If you like these essays, share them. If you don't like any of the above, tell me why and I'll learn.

Regarding, the podcast, I recently spoke with Eileen Murray, the former co-CEO of Bridgewater. The full conversation is here, also on Apple, Spotify, my website, etc. Two things struck me in the conversation. First, the story of someone who made it from the projects to the boardroom. These stories remind us of the power of thinking BIG. Dreams and aspirations matter. Second, she spoke about her definition of management. In her view, the primary role is *development*. How many managers do that? Her answer: "not many." I agree. Next week's podcast will be with an old friend, Pierre-Yves, who recently stepped down as Chairman of SocGen China. He discusses what he learned from fighting a war, an uprising in Mexico and living in China. He also shares his view on the European Union. Spoiler alert: not good.

Regarding investing, the below is derived from a column I published this week in the *South China Morning Post .* I recalled the the first coup I watched, in 1993, in Moscow, with the one last month in Washington, D.C., where I grew up. In Moscow, rebels targeted two spots: the Russian White House and the TV broadcast center, Ostankino. Watching the rebels storm the US capital, I had a sense of déjà vu only this time Twitter mattered more than a TV tower.

The proximate cause of January's attempted putsch was misinformation. Some of those attacking believed they were targeting a cabal of Satanist pedophiles. In shutting off

Trump's account, Twitter's CEO momentarily wielded more power than the entire US Congress. This decision was applauded by many Democrats and condemned by Russian dissidents like Aleksei Navalny, whose anti-corruption movement depends on the same tools used to spread conspiracy theories in the US.

In terms of investing, I took away two points.

First, President Biden has 24 months (until mid-term Congressional elections) to demonstrate to 74 million Trump voters that following existing rules will produce meaningful improvements. If Biden is unsuccessful, in 48 months US Democracy may be overthrown, which is such a disruptive idea it is difficult to put into print. After all, Hitler didn't succeed at first; 10 years elapsed between his beer hall putsch and Chancellor. Domestically, expect massive domestic fiscal spending. Internationally, expect a continuation of efforts to confront China, a position that now has bi-partisan support.

Second, many of the top US tech stocks enjoy enormous profits, economies of scale and unprecedented power. What qualifies a tech entrepreneur to decide life and death decisions, like that Trump is a threat and Navalny is not? Expect more regulation, a hit to profits and, ultimately, lower multiples.

Reform typically follows crisis, as seen in past low points in the US and other countries. The US Civil War led to amending the US constitution to abolish slavery and the Great Depression led FDR to abandon the gold standard. In China, Deng's reform and opening followed the Cultural Revolution, for instance.

Given the constitutional right to free speech, reducing the proliferation of conspiracy theories will be surprisingly difficult for the Biden Administration. The most substantial change would be if the Congress held internet platforms like Facebook (2.7 billion users) to the same legal standards that it currently does publishers like The New York Times (7 million users). While not likely, a whiff of this becoming reality and the targeted stocks will tank. It's interesting that Fox has been sued (successfully) for publishing mis-information. At present, that can't happen to Facebook.

The inability to easily crack down on false information puts even more pressure on Biden to enact policy voters can see with their own eyes, like Covid control and infrastructure. Traveling in rural China, I was struck by how new airports and faster cell phone service created a very tangible sign of better living standards. At first glance, China looks much more stable than the US. However, given that open debate is forbidden, it's hard to know. Many countries are experiencing significant tension between the countryside and cities. Given the rural/city split in the US, if the US population was slightly less urban Trump would likely have won. As far as I can tell, this tension exists in China as well.

The enormous change in communication infrastructure between the Russian coup and the attempted US one is creative destruction in action. Starting in the 1700s, there have been waves of disruptive innovation, from steam power to railroads to electricity to cars, computers, and the internet. The next innovation wave will likely include a merging of biological, computer and internet innovation to radically revamp industrial inputs, medicine and transportation. Appropriate law (be it taxes or regulation) always lags innovation, it's tough to figure out what rules apply, but eventually catches up.

Change rattles people even as they are mesmerized by it. Many of the people who attacked the capital were caught when they utilized this new technology to post selfies of themselves breaking the law. In the US, rapid economic change is also mixed in with racial shifts, like having had a black President. How would Germany's far right react if a Turkish-German became Chancellor? Make America Great merged economic, cultural and racial fears into a political platform. China's economic success combined with President Xi's more aggressive foreign and domestic policy both fed into this narrative and became easy to villainize, which I find tragic as I cherish relationships in both China and the US.

The most likely US policy shift is a massive fiscal program on Covid relief and infrastructure. The COVID spend is relatively obvious. Researchers suggest that 1 in 4 American families are now short of food. More Americans have died due to Covid than in World War 2. US infrastructure is well behind places like Singapore, Switzerland and Germany. An infrastructure spend can create jobs, precisely the type of jobs that would lift salaries and not require a college education. If I was in the Biden Administration, I'd be pushing for a significant commitment, bigger than what is now on the table.

The question will turn on financing. The real cost of government borrowing is *negative*. While the US is already highly indebted, the cost of that debt is a market driven interest rate. Biden can spend until those rates go higher and rely less on tax increases or at least immediate tax increases. Increasing the supply of dollars should reduce their value. My asset allocation remains long stocks in US and China, where much of the next wave of tech innovation will occur (though avoiding the name-brand stocks), short the dollar and long foreign bonds, including those in China, to hedge the risk that policy makers pull back on stimulus too early and the virus mutates such that vaccines are less impactful than we would all hope. At some point, US bonds will come under pressure. This is the most likely catalyst to do in the US stock market, higher rates will compete with money going into stocks.

Fathers, Sons and Money

In this month's **Things I Didn't Learn in School** podcasts, I share two conversations with men who have each had remarkable and quite different journeys. Pierre-Yves Bonnet was born in France and has lived in the US, Mexico, Spain and China. A key moment in his life came when his father insisted he learn two foreign languages. Roger Johnson was raised in Bridgeport, Connecticut, lacked the daily presence of a father, served time as a young man and went on to found an organization that helps get ex-cons and others on their feet and also became an involved father and minister. In both conversations, the relative impact of a father's presence or absence is a thread. Click on their names above to listen or go to my website or Apple podcasts. (And if you like these conversations please submit a rating on Apple).

These podcast conversations grow out of my experience with readers following the publication of *Raising a Thief*. Many readers said, "your story reminds me of…" something in their own upbringing. I realized many people could write a memoir about their family, work or both. Shameless plug: if you've read *Raising a Thief* and posted a review, thank you. If you haven't, the audio book is now available as well as the print and e-versions. Spread the word.

In terms of investment thoughts, my 26-year-old son recently asked me a simple question. "Dad, you used to do this for a living, what's your advice to my generation about how to invest?" Similar conversations typically mention things like Tesla or bitcoin. What follows is my answer. Feel free to forward to others if you find it useful or tell me where you disagree.

My short answer to my son: have an investment framework and deviate from it consciously, knowing the risks.

Here is a stripped down version of framework, which I've consciously made more digestible, aimed at a mainstream audience rather than investment specialists.

1. To invest, you have to save. Adjust your lifestyle so you spend less than you earn. Money = freedom. If you value your liberty, save early and often.

2. Investing money is like nutrition. Aim for a mix of ingredients. A combination of assets that spreads risks is called a diversified portfolio.
3. Wealth is created *and destroyed* via concentration. Most of today's billionaires, like Bill Gates, made their fortune by founding a company. But it cuts both ways. People go bust when their investments are concentrated, wealth is *preserved* via diversification.
4. Losing periods are costly because money compounds. If I have $100, a 10% return gets me to $110, 10% the next year gets me to $121. A steady 5% return means your wealth doubles in 14 years. If my portfolio drops by half, I need to earn 100% to get back to flat!
5. The basic investment ingredients are stocks, bonds and real estate.
6. Each major investment category has sub-categories. Stocks can be divided into emerging market, tech, value, or cyclical. Bonds into government, corporate, emerging, inflation linked, etc.
7. Assets compete with one another and their prices inter-relate. If bonds get expensive it makes stocks, as an alternative, comparatively more attractive and vice versa.
8. It's easier to compare investments if you put them in similar terms. Conventionally, socks are quoted in terms of price and bonds in terms of yield. I put everything in yield terms (more on this below).
9. Stock, bond and real estate pricing is mechanically tied to the interest rate set by the central bank. The Federal Reserve or PBOC if you are in China determines very short-term interest rates, called "policy" rates. The policy rate helps determine the interest rate on government bonds, which helps determine the price of stocks due to point #7, assets compete.
10. A currency allows you to own assets in a country you don't live in. A currency adds risk (it can lose value) to a portfolio but doesn't add return.
11. Stocks, bonds and real estate do well in different scenarios. By and large, government bonds perform well when the economy is weak, stocks when it is strong and real estate can be particularly useful when there is inflation. Almost nothing does well when a central bank is raising interest rates because all prices need to re-set to this new reality.

12. To predict whether stocks outperform bonds or which stocks outperform other stocks is hard. Unless you are willing to dedicate your life to figuring this out, don't try. Typically, people brag when they make money and are mum when they lose.
13. A useful starting off point is to put 1/3 of your money stocks, 1/3 in real estate and 1/3 in bonds with a greater than 10 year maturity. You could put more or less in each asset class if you have a belief that one of them will do better than another, but recognize the gamble. It can be fun to gamble and very gratifying when you win, but know the odds of each bet you place because you will definitely lose much of the time. The best investors (like Warren Buffet) are wrong about 40% of the time.
14. Borrowing money and buying assets increases your wealth and your risk. If you, say, buy an apartment or a house with borrowed money and lose your job, a painful squeeze can ensue.
15. Always have a margin of error.
Where we are right now.
1.   Governments are on war-time footing. The enemy is Covid. Governments are using whatever levers face the least institutional constraints. In China, top-down control and capital controls permit rigid movement controls that have largely stopped Covid in its tracks. As a result, the economic damage is less intense and the stimulus being offered is less intense. In the US and Europe given weaker population control Covid has done more damage forcing them to stimulate more than China. The US is stimulating the most for a number of reasons I won't get into here.
2.   In practice stimulation means the US Federal Reserve (the central bank) creates zeroes on a computer and uses that electronic ledger to go out and buy assets. The US Treasury can issue a bond and the Federal Reserve can print money and buy that bond. Presto! The US has created money and given it to the US government to spend on whatever it wishes, like stimulus checks.
3.   When the central bank is printing money and buying assets, it drives up their price, which is reflected in the low yield on all assets. For instance, the yield on the house I live in is around 4%. The yield on a US 30-year bond is around 2.2%. The yield on the S&P 500 stock index is around 3%. All these yields are historically low and relatively close to one another. The house is "illiquid" meaning difficult to sell, so it isn't surprising the yield is higher. US bonds look expensive compared to stocks.

4. Yields in emerging markets and China are higher. The yield on Chinese 10-year government bonds is around 3.3% and the yield on the Chinese stock market is closer to 5% (none of these calculations are precise and there are many different ways of doing them).
5. We are in the midst of a wave of rapid technological innovation that is touching manufacturing, bio-tech, industry and many other spheres that is disruptive and difficult to predict.
6. As a result of this framework and these conditions, I have more money in stocks than bonds, and half my stocks are held outside the US, particularly China. I've sold bonds (what's known as going short, or profiting from a decline in prices) in the US and bought them in China and other emerging market countries. I don't own any bitcoin or Tesla, whose yield is 0.1%.
7. There are always risks. One of them now is that bond yields shoot higher. If they get get above the yield of stocks, money is likely to come out of the stock market fast.

The Artist's Life and the Money Life

Last week I shared my interview with American sculptor Pete Beeman. You can hear the full conversation here.

A few things struck me. First, how courageous it is to set out on the path Pete walked down, combining engineering and artistic vision to make massive sculptures. As he said, if one aims at being a doctor or a lawyer, it is hard work but there is also a very clear path. For an artist, that's not true. Second, serendipity plays a critical role in creativity. Pete described the process around constructing Jelly, which you can see here. The sculpture moves (look at the videos), which Pete says he only discovered by accident at the end. It was at this point that the sculpture "worked." I don't recall who said art is 10% inspiration and 90% perspiration, but Pete's story seems to bear that out. Finally, there is the issue of money. Pete makes large public commissions and wonders, decades down his path, if there would be a private market for his work. Even amid the higher risk path of being an artist, there are higher and lower risk paths and every artist is forced to think about such things.

Since leaving the money world, I've spent a chunk of every day reading what I had overlooked before. One of the first books I read was Absalom, Absalom, by Faulkner. On the back page the author offered a piece of advice. "Read, read, read. Read everything-trash, classics, good and bad, and see how they do it." Following that dictum has led me to Don Quixote, Moby Dick, Master and Margarita, Soul Mountain (Gao Xingjian), No County for Old Men, American Pastoral, The Trial and the detective/crime writers Le Carre, Patterson, Lehane, Pelacanos (better known for creating The Wire), Winslow, Connelly as well as a pile of non-fiction books. I also bought a subscription ($50!) to the Paris Review which has interviews with leading authors going back decades. Conversations with writers from Gabriel Garcia Marquez to the poet Miloscz read as if they were interviewed this weekend.

A few observations about these readings that relate to my conversation with Pete. Creativity surges from some very basic source inside humanity. We are all creative, in different ways. How to source, channel and compensate this force will remain always uncertain. We both need to create and often feel the thrill when we connect with the creation of another. I found myself laughing out loud to Cervantes…written in 1605! Yet, Cervantes, credited with perhaps creating the best novel of all time, did not support himself as an author in his lifetime, instead working at jobs ranging from soldier to tax collector. Moby Dick, now well enough known that references to the tale featured in Super Bowl ads, was only recognized decades after Melville's death. Master and Margarita, written under constant threat of being shot by Stalin, came out after Bulgakov died in 1940. The same with Kafka. The detective writers I cited have had an easier go of it and while Marquez's first books barely sold, One Hundred Years of Solitude turned him into a global icon.

In investing (the subject of my next post) establishing the "value" of an asset is never easy. There are reference points such as a price to earnings ratios or the real interest rate but not certainty or reliability. Value applied to art seems to be a magnitude harder but no less essential. Art is something that we both consume and produce and discerning the logic to either requires patience, a tolerance of ambiguity and a willingness to suspend any immediate connection between perspiration and lucre, even while recognizing how essential the practice is to civilization itself.

The Cost of Conflict

Likely all of us registered, perhaps out of our peripheral vision, that Chinese and Americans sat down last week at a hotel in Anchorage, Alaska and that there was a "clash" and "posturing."

Regular Chinese and Americans, unlike the people at the table, barely know each other. About 42% of Americans hold a foreign passport and only a fraction of them have been to China, perhaps one or two percent based on tourism data. About 9% of Chinese hold a foreign passport. I suspect the vast majority of people on both sides want similar things—a cozy place to live, decent grub, some scratch and connection to close friends and family. Yet, we appear to be gearing up for a duel, possibly over Taiwan, maybe over islands almost no one can find on a map.

In this context, I tried to calculate for the cost of conflict. The true cost of conflict, which I will define as efforts to forcibly shift borders or ideology, is incredibly high. The cost is much higher than a direct calculation like military expenditure or lives lost; an accurate measure must include all the things that might have been had that violence been avoided in the first place.

I am not the only one who feels a vague sense of impending doom. Google searches on "US China Conflict" are at highs (credit this chart and an additional one further down goes to Rose, a company founded by Alex Campbell).

Over the long-term, economic growth is driven by how inventive we are. In econ speak, this is called productivity. In plain English it means getting more done for less, like plowing a field with a tractor versus a horse. What are tomorrow's "tractors" in terms of transformative technology? No one knows for sure. What we do know is that we are in the midst of a disruptive, transformative wave of productivity and that there will probably be great inventions in both China and the US.

We interact with the outlines of this futuristic world every day. I write this overlooking Long Island Sound, having just spoken over video conference with a Google employee in Delhi about a book advertising campaign (shameless plug: buy, review or recommend *Raising a Thief*). The video somehow flowed through my telephone hotspot. We chatted about the relative speed of vaccine distribution in Delhi and Connecticut, a vaccine created in record time. The list of such innovative moments goes on and on.

Amid such wonders, fighting over land seems anachronistic, yet that is where we are. Nationalism blooms despite how dated the concept. The primitive parts in all our brains that instinctively fear change, doubt people who don't look or talk like us and sympathize to those that do remains intact. Calculating politicians tap into those primitive urges. Also true: the cultural collisions this new technology accelerates are real. China has had an emperor of some form for thousands of years, the United States was founded on the idea that living without an emperor was enormously preferable.

When tension spills over to violence, productivity plummets and wealth is destroyed. The US invasions of Iraq and Afghanistan cost around $6 trillion. This money could have been used to do many things, like fully upgrade the US's creaky infrastructure. The untapped contributions of those that die in these conflicts is of course unfathomable.

The "track record," in trading parlance, of poorly conceived military ventures is long. German wealth was wiped out (twice) in the first half of the 20th century. Because we tend to measure wealth in our own currencies, an external reference point is required. The chart below shows gold measured against the Deustche mark. The 1923 hyper-inflation triggered by efforts to pay war reparations followed by the second world war eviscerated German wealth. The step change up in the chart is when the Deustche mark collapsed. (Geeky point, this chart is in log terms and the axis is 0 to 1).

Yet, the scars from conflict run far deeper. The true cost was the enormous productivity to be gained had Germany chosen another path. For instance, German mathematics has yet to recover because the top talent left.

The closest recent parallel to a potential US-China clash is Crimea. Russia invaded Crimea in 2014, a decision enthusiastically supported by many Russians and one the Kremlin deemed in its interests. In response, the UN general assembly passed a resolution by a 100-11 affirming Ukraine's territorial integrity. The US and Europe applied sanctions.

Prior to the invasion, the Russian ruble was trading at 35 to the dollar. In the wake of the invasion, the ruble fell to 80 and has yet to meaningfully recover. (An important footnote: concurrent with the 2014 invasion, Saudi Arabia increased oil production, leading to a collapse in the price of oil, Russia's key export).

Just as German mathematics suffered after WWII, the Crimea invasion also left a lasting scar on Russia. This is most clearly evidence is how much it costs to borrow money. Without getting into all the nitty gritty, this cost is much higher in Russia. (Ten-year government interest rates are below 2% in the US, around 3% in China and closer to 7% in Russia).

A high cost of capital impairs investment, which directly relates to economic growth. Russian household debt is around 20% of GDP. By contrast, the US is closer to 80% and China 60%. Russian GDP is around $1.7 trillion dollars. If their household debt levels were closer to China's, since 2014 Russia would have produced another $600 billion of spending. In other words, China-like growth rates.

Bad foreign policy decisions directly tie to things we can see and touch. The aging bridges I drive over every day are in some sense tied to the decision to spend US treasure abroad. When Chinese visited the US in the 1980s they say (see my podcast with Gao Xiqing) that America seemed impossibly bright and clean. Today's Chinese students, I am told, are shocked by how decrepit the US is. And Russia's decision to invade Crimea, a decision that most of the world sees as a violation of international law, directly relates to Russians living in small apartments.

I am so far betting the odds under Biden of such a conflict turning truly violent are low. I am long stocks and bonds in the US, China and even, a bit, in Russia. (I had been short US bonds, but I no longer am). I wonder if I am too optimistic on the likelihood of avoiding a clash. Negative views of China have exploded. According to Pew polling, a majority of people in the US, Europe and much of Asia hold negative views of China and President Xi. If the status quo around either Taiwan or the South China Sea shifts from posturing to actual conflict, not only will my asset allocation be in danger, the hit to productivity will last for decades to come.

Happenstance

Wednesday, I will publish my 18th podcast, this one with NBA star, businessman, father and husband Pat Garrity (available on Apple, Spotify, etc). As I reflect on my conversations with my guests, one thread that runs through them all is the role of a) happenstance and b) response. Happenstance is random, response is often creative and intentional.

What initially attracted me to macro investing was the search to name the big economic forces. These forces, like technological innovation or deflation, could create and destroy companies or, even entire empires, like the British or the Soviet. However, I've come to see that the list of forces that overturned my guests' lives was much broader than the ones I had studied as an investor.

For some, happenstance was being a child during a remarkably tumultuous historical period. My two-part interview with Gao Xiqing is a case in point. He describes being a teenager early in the Cultural Revolution and, at 13, riding China's trains for thousands of miles with his *younger* brother as company! His ended up becoming a lawyer, in effect studying how the fair application of rules can reduce chaos. Similarly, Iskander

Enikeev came of age at the same time his country, the Soviet Union, was imploding. He describes being “drunk” on freedom.
For others, chance was something unusual that happened in their home. Paul Cooke’s father took his own life. I asked if he was angry at his father. Paul answered in the negative. Instead, it made him curious about why someone would do such a thing in the first place. He also described how part of the allure of athletics was a sense it brought of “being in the moment.” We all crave flow. Paul’s life has been dedicated to finding it, that’s what makes the boats he coaches fly.
For others, happenstance was growing up without a lot of dough. No one choses to be born into a family with less resources. Eileen Murray and Roger Johnson each witnessed violence first hand. A difference was that Eileen grew up in a warm, supportive family and Roger was, in his own words, a latch-key kid. For Eileen, those early experiences seem to have translated into a street smartness, awareness of how money works and a sense that teamwork can achieve remarkable things. In Roger, these experiences manifested similarly, but also seemed to influence him prioritizing being the father for his own kids that he didn’t experience growing up.
Sometimes happenstance is *physical*. Both Pete Beeman and Pat are unusually tall. Peter found his physical size intimidated others and he learned to be low key in social events so as not to rattle people. However, his sculptures are huge, which he said was a way of, in essence, sharing size in a way that people found engaging rather than scary. Pat describes being unusually athletic but then, in high school, sprouting to such a height that it seemed like a relatively logical step to start spending a lot of time with a basketball. Neither of them worked for their height, it just happened, like the Cultural Revolution. The response, the effort required to become a sculptor or a basketball player, is of course intense.
Finally, for some guests happenstance was encountering a foreign culture. Pierre-Yves’ father insisted that he learn two foreign languages, English and Spanish. This then would lead to an international career that spanned fighting in the Gulf War, marrying an American, interviewing rebels in Mexico and running a bank in China. Andrew Weiss was drawn to a particular culture, Russia, and his deep expertise has defined his career.
When I finished *Raising a Thief*, I suspected most people probably had an equivalent story, just not the time or inclination to tell it. I am now convinced that is true.

Remarkable things happen to all of us, well outside of our control. Then it is up to us to decide how to respond.

In that regard, Covid is more happenstance, this one hitting all of us at once. Perhaps the last time the world went through such a simultaneous convulsion was World War II. How will we chose to respond? There is the invention of the vaccine, a miracle. I also sense a burst of creativity and risk-taking afoot. Covid is a stark reminder of how short our time here actually is and how fleeting the moments when we can put our hand to the tiller, as opposed to merely enduring a gale, be that gale economic, emotional or a pandemic.

If you have feedback on these posts or the podcast, please pass it along. If you know of others who you think would make good guests on the podcast, please let me know.

Man’s Search for Money

al to human existence, yet viewed as something private, best discussed, if discussed at all, behind closed doors with a specialist or a life partner.

As a kid, I couldn’t figure money out. I stared uncomprehending at the Business Section of *The Washington Post*. Who was Dow and Jones and what was an “industrial average”? I observed my Russian-born grandfather—gray hair, gray mustache, high-school education—listen with the utmost seriousness to the daily stock market report on, as I recall, AM radio. He’d lived through the Great Depression and it felt like he might be scanning for the next one. Some families were richer, others were poorer and I didn’t know why.

A new chapter in the never-ending money story is bitcoin. My exploration of bitcoin both involved talking to an expert, Michael Casey, on my podcast (please rate it on Apple podcasts if you are enjoying these shows!) and also doing some digging myself. This combo ultimately ended up in a piece in *The South China Morning Post,* which ran today and I excerpt below:

There are two perspectives useful to think about bitcoin: within the sweep of history and as a part of a portfolio.

Bitcoin is a currency, like the dollar or euro or renmimbi. **The question of a) how much currency to create and b) who should be allowed to make that determination is a fundamental question that has over time never been fully resolved**.

While most people find talking about the money supply boring, the question of how much currency to create is critical for social stability. If either too little or too much money is created, the economy and society become unstable. If the money supply grows at the appropriate rate, the consequent stability creates the requisite conditions for innovation, boosting the standard of living and many other things we associate with good times.

Throughout history, currencies come in two forms, those whose supply is flexible and determined by committee, and those whose supply is constricted and determined by some non-human force, like nature for gold or an algorithm for bitcoin. A flexible system can reduce economic volatility by expanding and contracting the money supply as needed. A fixed system eliminates the risk of inflationary money printing.

The inability to adjust the supply of money can be catastrophic. While it seems like distant history now, some of the worst periods of economic growth occurred in the 1930s when central bankers tried to maintain a gold peg during an economic crisis. A terrible depression followed. My grandfather and father lived through this.

Freeing masses of people from being tied to the gold standard consumed years of economic debate before central banks finally abandoned this policy. To end the depression, the authorities had to print, as the chart below provided to me by Alex Campbell at Rose shows. This happens again and again.

On the other hand, Zimbabwe and Weimar Germany are examples of how much damage a flexible money supply can create. Intuitively, I am much more attracted to flexible systems that can evolve.

The draw of bitcoin today is due both to its novelty and because developed world central banks are pursuing novel policies that might translate into inflation. In addition, unlike gold, which is difficult to use in transactions, bitcoin can be used to conduct commerce.

The central bankers doing the printing believe economic circumstances—high unemployment, millions hungry—justify their policy and don't believe what they are doing will translate into high inflation. I agree. The enthusiasm for bitcoin is a hedge on central bankers making a mistake.

In a portfolio, currencies play a specific role. Unlike a stock, bond or real estate, currencies have no claim on an underlying cash flow and *zero* expected return. Currencies rise and fall against each other, but they can not in aggregate rise.

Adding a return stream to a portfolio that does not produce a return makes sense if it reduces risk. For bitcoin, that could occur in two ways. First, if the domestic currency is likely to rapidly lose value. Second, if this asset *reliably* rises in value when other assets fall in value, meaning that bitcoin is diversifying.

Certainly, if major investors were to decide to make an allocation to bitcoin, more demand would meet with limited supply and the price would rise. In this sense, owning bitcoin is a bit like owning a lottery ticket; low odds but potentially immense pay off. That is one scenario and probably argues for a small allocation. There are however other scenarios.

As Covid recedes, the printing will likely decline. This has already occurred in China. Moreover, I don't understand the technology that limits how much bitcoin can be produced and, as far as I can tell, most people don't. Bitcoin is less than 20 years old. Perhaps something better comes along or technology shifts and the price plummets?

The correlation benefits of bitcoin are also uncertain. A good portfolio contains assets that rise in value over time, but rise at different points in time, thus dispersing the risk. With bitcoin, these relationships are less clear because the history is so short.

If global printing produces global inflation, it seems logical that bitcoin would go up in value. Yet the big rise in bitcoin has come at period of *falling* inflation. If inflation does come, would investors choose other assets instead, such as inflation linked bonds, gold, other commodities or real estate? It's also true that ascertaining the correlation of any currency is fraught.

Finally, there is the regulatory risk. Given that bitcoin isn't centrally managed, it is attractive for criminals as well as investors. How will regulatory entities respond to bitcoin, particularly if its popularity grows? I don't know. If the regulation shifts, bitcoin could fall significantly.

I welcome the evolution of financial systems and find bitcoin an interesting step in that process. However, when it comes to saving and investing, I am attracted to assets that are simple and whose characteristics are understandable. For me, bitcoin doesn't meet that test or meets it in such a murky way that at best I could hold a very small allocation as a sort of experiment. Right now, I don't hold any.

Playing Chess with Putin

The US leveled sanctions on Russia this week, using what was regarded as the "nuclear option," targeting Russia's bond market. Based on both market pricing and the tenuous connection many Russians will make between financial conditions and Putin, I suspect the bomb missed the mark.

When I think about sanctions I look at them both through the eye of an investor and the prism of conversations with my 91-year old mother-in-law, Maria Alexandrovna. She grew up under Stalin, lives in Moscow and consumes a steady diet of Russian state-owned news, news that makes Fox seem like NPR. She doesn't know what a bond market is.

US investors are now forbidden from buying Russian bonds at auction. They are still allowed to buy them on a secondary market. Primary and secondary are technical terms. In plain English, this means on the day the bond is issued, a US investor can't buy it. But if the investor buys the bond the next day from someone who is not the Russian Ministry of Finance, it's OK.

At a White House briefing, a person identified as a "senior administration official" said "when you remove US investors from the primary market it causes a broader chilling effect. **Russia's borrowing costs rise, you see there is capital flight, you see the currency weakens in tandem**." So the goal is to drive borrowing costs up and the ruble down, hurting the Russian economy and, presumably, weakening support for Putin.

Exchange rates are a relative price, how many rubles you get for a dollar or a euro. They are determined by supply and demand. Demand for a currency comes from exports and the attractiveness of domestic capital markets. Supply comes primarily from the central bank though credit also creates currency supply. (If you take on a mortgage you are creating dollars that were not there previously).

To accurately forecast an exchange rate, one needs to predict the relative shift in each one of these line items, which is where the complexity comes in. For instance, the US exports entertainment. What will be demand for US entertainment over the next year from foreign buyers? It's hard to say.

People who speculate on currencies tend to realize predicting these line items with precision is impossible and instead focus on a few variables. When assessing the sanctions against these variables, the policy is facing a headwind related to market pricing and relative central bank policy.

In terms of currency supply, the US Fed is pursuing an aggressive (and for now appropriate) policy of printing to deal with Covid economic shocks. Millions are unemployed and hungry. A by-product of this is that dollars are being created at a very rapid rate. That's why interest rates are so low.

By contrast, the central bank of Russia is **tightening**, or reducing the supply of rubles. They are doing this for a number of reasons but one of them is that inflation is higher in Russia than in the US, 5.7% versus 2.6%.

Regarding currency demand, when an investor buys a foreign stock or a bond, they get a package deal, both the asset and the currency in which the asset is denominated. If the underlying assets are attractive, it tends to attract capital, supporting the currency.

Russia's economy is primarily driven by raw materials, like oil, aluminum and palladium. These prices have been rising quickly driven in part by expectations of global recovery and the Biden Administration's infrastructure plan. This means cash flows in Russia are likely to improve going forward.

Despite a likely economic pick up, emerging market assets are trading at a discount relative to developed world assets. For instance, the yield on the S&P 500 is about 3% while the yield on the Russian stock market is around 5%. The yield on the hot stocks in the US is close to zero, meaning they are expensive.

Real (inflation adjusted) interest rates are negative in the US while they are positive in Russia. In real terms, at current prices investors are *paying* the US government to borrow money, which makes it hard to attract capital. By contrast, bonds in emerging market countries including Russia must pay investors to attract funds. So far, the major emerging market bond market index provider is leaving Russian bonds in their index.

Where the sanctions do succeed is in reinforcing the image of Putin's Russia as a pariah state. While I have no clarity into Kremlin strategy, I assume their tactics in terms of election interference and other schemes are a combination of an authoritarian leader, wounded pride and a sense that they are an underdog and can't fight fair. Russia's GDP is less than a tenth US GDP, a pugnacious welter weight versus a heavy weight.

This pariah image, cemented following the 2014 invasion of Crimea, has likely retarded investment that would have otherwise occurred but is already priced into the bond market. In terms of the sanctions' impact on markets, by Friday the return of Russian bonds and stocks, measured in rubles, was slightly *above* where it had been before the announcement.

As for Maria Alexandrovna, she believes Russia is blameless. I suspect the sanctions won't change her mind. To me, this is a reminder that even though we confront lots of obvious problems—in this case Russian election interference—sometimes figuring out the appropriate policy response isn't easy.

Four Big Forces and the Cherished Oddball

Macro investors distill the big forces flowing across economies into a collection of investments. This process is a bit like painting a picture of what the future might bring. However, unlike painting, whose veracity is often only seen clearly many years later, an investor can test the accuracy of their theory daily, the same way an athlete can check their prowess in competition.

Over many years trying to learn the art of macro, I found it is a field that rewards oddballs. All known information is already embedded in the price. If you buy a share of Apple, the person selling it to you already knows Apple makes cool products, that there is a new, faster iMac out, etc. To do the trade, you must see something ahead for Apple that the seller doesn't yet perceive.

Regarding uncorrelated people, this week on the Things I Didn't Learn in School Podcast I aired a conversation (click link) with Lois Letchford, author of *Reversed.* She describes raising a son who struggled so much in elementary school the teachers asserted he was low IQ. Lois, through a circuitous journey, was able to unlock her son's talents, who went on to earn a PhD from Oxford. Despite his success, recalling those first years at school when he was an outcast is still painful to him, a reminder the social group tends to embrace oddballs when they succeed, not amidst their inevitable struggle.

With that preamble, here are the big macro forces I see.

1. Innovation.
2. A Fiscal Push.
3. Climate Change.
4. US-China clash.

I'll first define the themes and then scratch the surface regarding investment implications, following up with another post. These themes are all intricate, inter-related and each has their army of experts.

Innovation. If you look at a chart of productivity, it is flat for hundreds of years and then begins turning up sharply in the 18th century. We now live with all those inventions—electricity, clean water, cars, computers. These seem commonplace in retrospect but were all wildly disruptive. What did it feel like to be a master saddle-maker when car production exploded? We are in the midst of another innovation wave now linked to a nexus of technology and biology. Little hints of what is to come are already here—food that looks like meat but isn't, 3-D printing, watches that tell time and monitor our health and vaccines delivered at a speed and precision that is unprecedented. Much more is to come.

Fiscal push. The Biden fiscal spending plans are so large they are difficult to contextualize. Passed and intended future plans amount to something like $10T. The entire output of the US economy, 330 million people strong, is around $20T. Typically, stimulus occurs when the economy is weak (which is what happened over the last year). Biden wants to *keep* spending when the economy has recovered. The logic is political as much as it is economic. The simplest explanation for Trumpism is exasperation over flat wages. A multi-cultural society is easier to engineer if living standards are rising as opposed to, as they were for a third of Americans, flat or falling. Given that mid-term elections are 18 months away, Biden has a window of time to change the expectations of those who are predisposed to dislike him and a massive fiscal push to rectify chronic domestic under-investment makes sense.

Climate change. This has gone from Gore's inconvenient truth to an obvious truth. The more volatile weather shifts Gore predicted 15 years ago are now a fact of life, like the tornado that touched down in my New England town. Among the more shocking elements of climate change, a less discussed one is one Spencer Glendon from Probably Futures introduced me to: climate refugees. When it becomes too hot to live in parts of Africa and central America, people need to move. What will happen to the places they move to?

US-China. Armed conflict between large countries with significant militaries hasn't happened in almost 100 years. It is now an increasing possibility. While there are lots of way this could happen (like Russian and US planes colliding) the most likely known unknown comes down to the calculus of one person, President Xi, about the relative importance and status of a single island, Taiwan. Beijing's response to Hong Kong has hardened opposition to Xi inside Taiwan, according to Pew, and fomented bi-partisan American mistrust of China's government. Yet, most of Xi's actions are consistent with imminent reunification.

The investment implications of the above require more room. The cliff notes follow. I am avoiding stock market indexes altogether. Instead, I am utilizing specialists who I think have the best chance of buying the companies that will benefit from the tech shifts and selling the companies that will get hurt by them. I am doing the same myself. The Biden fiscal push will either a) drive stocks up a lot or b) drive real (inflation adjusted) interest rates up or c) some combo. If real interest rates rise enough, however, stocks will fall a lot. As a result, I am significantly short US medium-term bonds (attentive readers might note I went from short to flat to short again). I am avoiding investing in some parts of the world altogether, particularly Europe, which is a climate loser. I haven't decided what to do about the US-China issue and so far am doing nothing. One possibility is shorting the Taiwan dollar, another would be shorting TSMC, which is the Taiwanese chip manufacturer.

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Biden's Big Bet

Regarding the plan, when Biden said Xi and Putin believe democracy can't "compete in the 21st century" that rang true to me. My mind flashed back to a conversation I had had years before in an elegant Beijing restaurant. My interlocutor was a financially savvy Chinese acquaintance who had earned an advanced degree in the US, worked in New York for a period and then returned home. He was bald, wore a stylish black blazer and had a thoughtful manner. This was years before Trump and George Floyd.

"The US is going to collapse," he predicted, soberly. He cited crumbling infrastructure, school children murdered by mentally ill assailants with automatic weapons, racial strife, wealth disparities and a lumbering, unresponsive Congress. All the flaws he cited are real and dangerous. I heard similar things in Moscow, echoing the reports on state-run TV.

Much has changed since that Beijing conversation but, as an investor, two points standout—**the siege on the capital and the bond market**. Yes, the bond market. I know non-financial people glaze over when you mention the words but they matter, particularly now. The siege created an urgency around spending and the bond market pricing invites an aggressive policy response. This response will then impact asset pricing and geopolitics.

The capital siege rattled both Democrats and centrist Republicans. Suddenly, it was more obvious than ever that if the US didn't start to address its chronic problems more quickly the country would indeed collapse. The US has teetered before. The Civil War, Great Depression and Vietnam Era protests all come to mind. Each time, the crisis was enough to catalyze action and the system just barely flexible enough to find a new equilibrium, but only after the country had veered way off course.

Regarding the bond market, right now, the government is *paid* to borrow money. How can that be? A bond is a loan. While interest rates on US government debt are positive, inflation rates are even higher, meaning investors are, in effect, *paying* the US government for the government to borrow money, in real terms. In that sense, the borrowing spree is rational. If the market is willing to give the US government money at that price and a political crisis is at hand, why not use it?

The total bill of already approved and future programs will be roughly $10 trillion. For context, the US spent around $6 trillion on Iraq and Afghanistan. Based on Biden's speech, many of the things on the agenda include the very issues my dinner companion cited. While logical, it isn't normal.

Since Keynes (1883-1946), governments have typically used fiscal spending when the economy is *weak*. Biden is adding fiscal when the economy will be, as the vaccines kick in, *strong*. Meanwhile, the major regions of the world are pursuing very different financial policy. China is *limiting* debt growth, Russia is *tightening* monetary policy. Europe is using fiscal stimulus at a much more modest scale.

Biden's bet has significant geopolitical and investment implications.

In terms of geopolitics, US-China tension is unfolding against the backdrop and is linked to a rapid technology shift centered around bio-tech, chips, AI and green energy. The disruption from technology is part of what fueled Trumpism.

Biden's policy supposes an infrastructure boom that absorbs less educated workers combined with social spending will improve social and political stability. Making community colleges more accessible is one step in that direction, as Vanessa notes. Together, if successful, this will likely translate into improved productivity and US economic and military strength. Military spending has always been a function of economic strength. If, on the other hand, Biden's bet fails, the US global role will fade, much as Britain's has. It is this failure that Moscow and Beijing believe is almost inevitable.

In terms of investment implications, despite this possible spending surge, the US bond market is estimating (based on bond yield pricing) that US real borrowing costs will remain negative *for years*. **This is what has driven savers into anything that isn't cash**. Many stocks and commodities are up over 50% in the last year. Because these assets are disproportionately owned by the wealthy, income inequality has actually worsened.

Private sector forecasters estimate the US will grow at 6% this year and 4% next year. These growth rates are well above average. Over time, bond yields tend to track, if loosely, growth rates, such that the rate of borrowing is roughly in line with the aggregate rate of economic activity. This suggests bond yields are way too low. See below from my friends at Rose. The dot suggests where we are going.

If US interest rates rise enough, many asset prices will stop going up. Prices are determined by supply and demand and if interest rates on cash rise it makes sense that more speculative investments will become less attractive. That's what's already happened in China. Tighter Chinese policy this year has stopped the stock market in its tracks. **If Biden's policies are successful, it's possible many investment portfolios will get hurt**. While I largely welcome what Biden is doing, the only way I can own risky assets like stocks and commodities is by simultaneously putting on positions that will benefit from a substantial rise in US bond yields. This is what's known in the business as a hedge.

From here, I suspect either interest rates stay low and risky assets rise further, or bonds reprice and risky assets fall or some combination of the two. Not being able to predict an outcome precisely and construct a portfolio that can survive various scenarios is what makes investing, compared to politics, more contained. From a political standpoint, Biden's bet is as significant as those placed at other critical junctures in US history. If Lincoln went long civil rights and short slavery, Biden is long Main Street, short Wall Street.

All Companies Die

"With liquidity like it is, it's crazy not to get funding."

I was sitting on an unsteady metal stool drinking coffee on the lower East Side of Manhattan. The sun was finally out. Opposite me was a 30-something software entrepreneur whose start-up was already cash-flow positive. But why not turbo-charge it with funding?

In the short-term, the economy is accelerating. You can see it. The road traffic is thicker. The shelves at the grocery store—empty at pandemic peak—are full. And you can see it in the data. Economists estimate that the economy will grow 6% this year. Inflation is above 4%.

In the medium-term, something more substantial is afoot: companies are dying. Companies are always dying, the only question is the rate at which it is happening. Given both the disruptive nature of today's technology and the ease with which one can get funding, this death rate will likely accelerate, both from existing companies dying and junky companies being created on cheap money. This corporate life cycle impacts each of us.

Dropping Out

Apple is a key component of stock index averages, like the Dow and the S&P 500. It is valued, today, at roughly $2 trillion. I love the company. I am writing this on an Apple computer and wearing an Apple watch. And yet I know it will die. I just don't know when and exactly how.

One perspective on this cycle of corporate life is to see who is in the major stock market indexes over time. This is inexact because the criteria for who gets in and out is technical and a company can still be very much alive yet fall from the index. Still, I find the perspective helpful. Today the members of the Dow Jones Industrial Average are familiar names—in addition to Apple, companies like American Express, Coca-Cola, Intel, JP Morgan.

If you go back roughly 50 years, it's a different set of names—American Tobacco, Eastman Kodak, General Motors, Sears Roebuck and United States Steel. Go back 50 years before that, to 1920. The top companies include American Locomotive, American Sugar, Central Leather Company and Western Union. In the 19th century, the top companies include American Cotton Oil, Chicago Gas and Light, Tennessee Coal and United States Rubber. (After showing a draft of this piece to an early reader, they forwarded me a clip of Buffet noting some of these shifts).

My friends at Rose created the graphic below to illustrate this. Each blue bar shows a company dropping out of the DJIA, so Chicago Gas and Light is one bar here.

Chart, bar chart, histogram

Description automatically generated

The median time a company is in the average is 10 years. There are outliers, like Proctor and Gamble, that has been in the Dow since 1932! To go from the macro to micro, next week's podcast features photographer Paul Fetters, someone who lived through the film disruption and, of course, the implosion of Kodak.

The Corporate Life Cycle

Companies are unstable because the economy shifts, technology evolves and companies need different types people at different stages of life. The mix is as unstable as a radioactive element. Academics study corporate failures the way the NTSB studies plane crashes. I'm partial to the work of Ichak Adizes who describes a lifecycle that runs from courtship and infancy to prime and then the fall, ending in recrimination, bureaucracy and death.

The evolution in the people required is curious. Given the (low) odds of success, you need to be a bit crazy to start a company. As Elon Musk said on his recent SNL appearance, “I reinvented electric cars and I’m also sending people to space in a rocket ship. Did you also think I’d be a chill normal dude?” If a business succeeds, it gains scale and complexity. This complexity creates a “moat” that protects the company and throws off cash flows. The administrative and people skills required to manage this complexity favor “chill” normal people. These people are both the glue that holds an organization together and unlikely to embrace disruptive ideas.

Implications

Given the above, a few guidelines I stick to that may help you as well.

1. I avoid concentrated investments in a company; I hold no more than 1% in a single stock.

2. I avoid stock market indexes (like the S&P 500). These indexes, particularly now, have a heavy weight to large, well established companies like Apple and Amazon whose greatness is already well recognized.

3. I don’t own long-term corporate debt, both because I suspect very low interest rates will rise and because the risk the company isn’t around is real.

4. When I was granted stock options (when I worked as a banker), I tried to liquidate them as fast as possible. Working at the bank already gave me plenty of exposure to the company. Of course, if you are at a start-up that you deem likely to undergo what Adizes describes as “infancy to prime,” stock options could be a rocket ship.

Instability is normal, unnerving and essential. The key question is always one of degree. The software entrepreneur I spoke to is out to take someone’s lunch, it’s just a question of whose.

If you want my current asset allocation (which changes a bit each week), give me a shout. The essence is long risky assets, long raw materials, short US bonds and long foreign bonds, among other positions.

How Not To Die On Vacation

Forty feet, said Henry.

I’d just asked about the largest wave he’d ever surfed. He took a drag on a cigarette and a sip of coffee as he stared at Lyman’s, a surf break supposedly favored by King Kamehameha himself. The waves made a loud “boom” when they hit the sharp coral reef before us and a “shush” when they receded. Henry said he’d been surfing for 60 years.

On a wave that big, what happens if you crash? I asked.
I can hold my breath pretty good … I free dive, two and a half minutes under I'm good, he said. He smiled, finished his cigarette and grabbed his board.
Second to perhaps sleep and becoming a parent, travel forces a perspective change. We encounter the unfamiliar. This is vital. At the same time, precisely because it is unfamiliar, it is harder to accurately evaluate risk.
Water seems to be a particular challenge. A visitor is 13 times more likely to drown in Hawaii than at home. According to the US State Department, about 1000 Americans die while traveling abroad each year, typically in a car accident. Right after automobile crashes comes drowning.
When I got home, I pulled *Deep Survival* by Laurence Gonzales off the shelf. It's a book about "Who Lives, Who Dies, and Why" in extreme situations. He has a chapter on drowning in Hawaii. "A scientist named Chuck Bly did extensive research on death by drowning in Hawaii … the rate was directly proportional to the number of tourists who came to the island. Put another way, drowning is normal."
Our ancestors walked about six miles a day. That's one perspective on the rate at which we are programmed to adjust to change. Now we are forced to adapt much faster while at the same time being cocooned in risk controls that we don't fully acknowledge or even understand.
I'd covered the 5000 miles between home and Hawaii in a day, traveling in a plane with layers of engineered redundancy. My phone transmitted the current information revolution. We are becoming experts in blocking information out. The combination of speed, safety nets and information overload makes it *harder* to spot when we are faced with real risk.
Thinking about the waves, I drew parallels to investing. A wave has many different moving parts—tide, current, wind, ocean bottom, angle, frequency, temperature and distant seismological events. Investing is similar. You must take risk to make money, there are many moving parts and none are precisely predictable.
At first glance, investing looks simple. First, become familiar with the price of an asset. Second, learn how to combine that single asset with another asset. The combination of assets is what's called a portfolio.
When it comes to buying and selling things that are familiar, most people are pretty good. They know a loaf of bread costs between $2 and $5. At $20 they'd consider it

ridiculous and at 20 cents they suspect the bread was made of sawdust. Investments are more like waves (many moving parts) and less like bread (water, salt, flour).
Consider real estate. Typically, you take on debt to buy. There is maintenance, taxes. You get rent and a physical structure in return. The rent minus the costs are your profits. Divide profits by the cost of purchase and you have your yield. All assets have yields, they compete and you can compare them.
Yet, there are moving parts within the moving parts. Interest rates on a real estate loan are determined both by the interest rate on government debt plus your own personal credit risk, the risk you don't pay back the loan. Understanding the interest rate on government debt is an entirely separate essay.
The rent also has moving parts. This has become particularly clear during this pandemic. There can be huge swings in demand for a structure. For instance, a Covid-led permanent shift to more remote work equals less demand for offices, so prices fall. Some office buildings in mid-town Manhattan have been appraised at *20%* of their pre-Covid prices. At the same time, there is a surge in demand for suburban homes. The point: no investment is ever a sure thing, ever. For sure when people bought the mid-town Manhattan buildings a pandemic was far from their thoughts.
The chart below (from Rose) shows the loss from peak of 30-year bonds, US stocks, Amazon and bitcoin. Each of them at different points in time has almost entirely wiped out your wealth.

Pairing assets is a way of reducing this unpredictability. I utilize a 1/3, 1/3, 1/3 approach to investing, stocks, long-duration bonds and real estate, as a start. I am surprised that savers who lack an asset allocation will leap into crypto. (***NOTE: this isn't investment advice. I am sharing my thoughts, not telling you what to do***).
After staring at the surf for a while, I paddled out. A wave came. I grabbed it. I was moving along, the water gathering strength under my board. Then, suddenly, the tip of my board sunk sharply. I pitched forward, trying to avoid hitting any coral, hard as concrete.
A moment later a surfer paddled up.
You know why you fell, right?
No, I said.

There is a big rock, just under the surface. You surfed right over it. The water gathers strength and then boils, sucking your board down. Next time, go around it. Otherwise, you can whack your head.

I will continue to travel and surf and speculate. I also know there are submerged rocks all around us. Experienced surfers drown. Experienced investors sometimes get wiped out. Risk can't be avoided, only managed. Hawaii was a good reminder about slowing down when facing the unfamiliar.

Deflationary Locusts

"Mark my words, we are getting double digit inflation, like the 70s."

I was at a Utah ski lodge with my kids. We ate family style, shared tables. The guy speaking at mine was fleshy and loud. This was not long after the 2008 financial crisis and the Federal Reserve was printing a lot of money. In the Middle Ages, this would have been done by pounding gold and silver into coins. These days a central bank created zeroes on a computer.

I looked at other people at the table. Blank faces. My guess was none of them thought much about interest rates or inflation. For many years, these were mystery topics for me as well. My dinner companion turned out to be flat wrong. Inflation over the next decade was about 1.5% a year. Predicting anything with a lot of moving parts is hard.

Inflation impacts you, even if it isn't something you think about day-to-day. When inflation goes up your own wealth—measured in the ability to buy what you want—goes down. The cost of a loaf of bread was $1.37 in 2008 and $1.52 ten years later. When inflation gets out of control, it creates havoc. Think Weimar Germany and food shortages.

Last week, we found out US prices rose 5% from a year ago, prompting news stories about how the Biden Administration's aggressive spending will lead to more inflation.

But it's also possible the post-pandemic world will do just the opposite, usher in changes to sectors—like education and healthcare—that have been responsible for most of last decade's inflation.

First, some background. Inflation is the average price change in the things you buy, composed of thousands of individual prices, each determined by supply and demand. Despite lots of research, no one knows exactly how all these supply/demand interactions work. That was a point made recently by former Treasury Secretary Larry Summers. He noted we have theories about inflation related to how much money is printed, debt stock and the nature of inventiveness but not precise, predictive answers. We do know one reason you invest money is to outwit inflation. Saving is money for later. Later needs to preserve the ability to buy stuff so you need some investments that can gain value when inflation rises. That's one reason I have a chunk of savings in real estate and commodities, hard assets that tend to rise in value when inflation rises. These days, a group I refer to as deflation locusts can have a big impact on prices. Locusts set down on a crop, eviscerate it and leave. The modern economic equivalent of this is what happens when venture capital and the stock market fund software engineers who see a vulnerable industry they can rip apart, restructure and reallocate the profits. The middlemen gets crushed, venture capital and software engineers get rich and the consumer gets cheaper stuff. Uber to taxis, Amazon to retail, Apple to music are all examples of this. If it sounds aggressive it is; no one gives up their cash flow willingly.

Certain industries are more vulnerable than others. If you look at inflation over the last 10 years, the two biggest categories of prices rising are healthcare and education, as shown in the diagram below created by my friends at Rose Technology. Tobacco prices are also up, which I imagine is what happens if your customers are addicts.

Going forward, both healthcare and education seem like appealing targets for the deflation locusts, particularly in the wake of a pandemic that pushed us to break long ingrained habits, like seeing a teacher or doctor on-line as opposed to in person.

One reasons costs keep rising in these areas is because productivity, output per worker, is lagging. This is something known as Baumol's cost disease, a theorist who pointed out that symphony players are no more productive than they were hundreds of years ago but their salaries keep rising. While symphonies can not innovate, schools can. Constantly rising prices in education and health care suggest the innovation in other sectors is not hitting them or cartel like behavior is limiting supply or perhaps a bit of each. (I write this with plenty of affection for the classical musicians, teachers and doctors I know).

When I think about education, my mind goes to Khan Academy. It's free, higher quality than much of the instruction I received in school and can scale at almost no cost. Based on 2011 data, there are 500,000 math teachers in the US. How many of them are better than Khan Academy? Obviously there would be resistance from unions and others. But there is always resistance to change. Maybe some universities will be more amenable. Georgia Tech's Zvi Galil is a case study. How many introductory calculus and engineering teachers do we need? Will the locusts make higher education better, cheaper and more meritocratic?

Medical care seems similarly vulnerable to the locusts though perhaps from a different angle—cost control. Prices rise in part because a segment of the health care market is incentivized to charge for unnecessary procedures, in part because of inefficiencies, like bad data sharing. There are now entrepreneurs (like Garner health) and many others getting funding using big data to make medicine more efficient. According to Deloitte, venture health care funding doubled in 2020 vs 2019 and the easy capital raising environment is bolstering new company creation. As they do, it's conceivable that medical inflation slows even as new expensive procedures come on line that improve health but charge a premium to do so.

Given this, I am on the look out for assets that not only help me in a higher inflation environment, but also in a lower one as well. Government bonds are great for this (if you are confused about what a bond is write me and I'll explain). While I own foreign bonds, last year I bought protection against higher US interest rates. So far, this protection has been a bad bet. If we get more inflation and US interest rates rise, I plan on buying US government bonds as protection against low inflation. The deflationary locusts are out there, I just don't know how effective they will be when they pick their next target. That's why investing is tricky.

A Father's Role in Thwarting Crime

Many winters ago, New England sunk under snow, passing a Russian speaking family up a hill, all of us on cross-country skis, them perhaps not realizing I understood them. I'd put their boy at 5 or 6.

Look at Kolya, it's too steep, he will fall, said the woman, probably mom.

Then he falls, said the man, probably dad.

Evident was what child development specialists refer to as the father's unique role in facilitating "rough and tumble" play, a critical element in building resilience. Of course, a father's role goes deeper than that, based on both data and personal experience.

Regarding the data, a 2002 study of inmates revealed 40% of them grew up without a father; 85% of children with behavior problems are from a fatherless home, according to the Centers for Disease Control. Overall, statistics suggest having a present father seems to generally be a good thing. My podcast conversation with Roger Johnson poignantly describes the opposite. While a disruptive economy is essential for wealth creation, a disruptive childhood is not.

Regarding personal experience, some readers know the story of *Raising a Thief*. In 2001, my wife and I adopted a 16-month old child from Russia. I wrote a book about the experience and am speaking today at 3 pm on lessons learned on "What Happens Next In Six Minutes," a sort of compressed Ted-talk-like format.

Three observations stand out.

1. **The roots of conscience, curiosity and reciprocity begin with the relationship of child to primary caregiver**. This is called attachment. This process was first documented by English psychiatrist John Bowlby in the 1930s. When this bond is ruptured, a child's brain changes; they can exhibit anti-social behaviors, like lying, stealing, even homicide.
2. **A family with a difficult member often requires structural shifts.** While the specific challenge varies—mental illness, alcohol dependency etc.—a difficult family member forces a reckoning. In our case, I had to up my game.
3. **An ounce of prevention is worth pounds of cure**. Once a child has been damaged, it can be surprisingly difficult to treat. The US spends 0.5% of GDP on early childhood intervention, below the OECD average. After our experience, I think the risk/reward of early childhood investment is meaningfully undervalued.

More below.

Lesson #1 – The roots of conscience, curiosity and reciprocity begin with the relationship of child to caregiver.

The next time you watch a parent with a very young child, pay close attention. The micro interactions may seem banal. They are anything but.

I witnessed this scene with friends last week: an infant getting a bath, defenseless. Whoops! The infant slipped in the tub, got scared at the sudden movement and squawked. Mom instantly picked her up, wrapped her in a dry towel and said, "you are OK." The child calmed down. Neurologically, something fundamental just occurred, trust was built in mom and the world.

Dr. Bowlby was trying to understand why children steal. At the time, psychiatrists were in the thrall of Freud and believed childhood theft was due to repressed sexual desire. **Bowlby found in many cases, the tie to the thieves' primary caregiver had recently been severed due to death, illness, or war. Bowlby asserted theft was a "childhood disease" like mumps**.

Others have built on his work. Bowlby focussed mostly on mothers, not surprising given the time. The father is also crucial. Before we took our daughter in, she had been starved. While she was lying in a Russian communal apartment, her screams for food unanswered, her brain was being re-wired. She developed what's called an "attachment disorder." The birth mom was stripped of her maternal rights. Where was Dad?

The earlier attachment is damaged, the worse the effects, suggested Bowlby.

Such kids are emotionally disjointed, even if physically and intellectually robust. Like many mental health issues, the severity exists on spectrum. My wife was kidnapped as a child in Pakistan. Yet my wife is not only intact but flourishing. The difference, according to Bowlby's theory, is the timing of the disruption. My wife was 8.

Lesson #2 — A family with a difficult member often requires structural shifts.

When we adopted our daughter, we were ecstatic. My wife and I had been married six years. We had an adorable, biological son so we were broken in as parents. I worked as a banker, my wife as a teacher. We lived in the leafy, well-educated enclave of Brookline, Massachusetts. We knew Russia well. My wife is Russian. We met when I worked as a reporter there in the early 1990s.

We almost immediately encountered challenges. When our daughter could walk, she ran away. When she learned to talk, she began to lie. When she was old enough to be out of an adult's field of vision, she stole. These behaviors continued right through to adulthood when she was convicted of fraud. Many of her early transgressions were, in isolation, insignificant. She lied about tooth brushing, homework, hand washing, cleaning up her room, logging onto another family member's computer, laundry, petty theft, bullying others, etc. All kids lie. Our daughter had no other way of interacting.

This forced us all to shift. In particular, I had to up my game. Too often I had dismissed my wife, who was faster at seeing what was going on with our daughter. I would tell my wife to "calm down" and be "logical," which led to awful fights. As an adult, I have also had to set firm boundaries with our now adult daughter. There are conditions to unconditional love, both in terms of what I had to expect from myself and others.

Lesson #3 – Early childhood education is a great bang for the buck

My wife and I tried every intervention modern medicine has to offer—psycho-therapy, behavior modification, pharmacology, residential treatment, wildness therapy, parenting coaching, diet, neuro-feedback. Nothing fundamentally changed the underlying behavior.

Dr. Bowlby believed early intervention was key. While we took our daughter to a leading hospital in Boston and had a team of specialists evaluate her, no one either warned us about the risk or, once symptoms were present, accurately diagnosed her until she was 9. Too late.

My conclusion is that you want to do everything possible to prevent this from happening. What Geoffrey Canada has done with Harlem Children's Zone makes the most intuitive sense to me, though I am no expert in his work. What I do know is that they begin working with families the moment the child is born in the belief that "today's newborns as tomorrow's college graduates."

I generally share an investment implication in these posts. My experience and the data suggests it's harder to accumulate wealth if your childhood is chaotic and investing heavily in early childhood seems like a wise way to even the playing field. My motto is socialism for infants, personal responsibility for adults and part of that personal responsibility is for Dads to recognize their power, even if it is sometimes expressed in something small, like letting a kid tumble down a hill.

US & China Entwined

What'd you think when Reagan called you guys the evil empire?

It was a bluebird clear summer day in Moscow, 1990. I was studying there in what would turn out to be the last year of the Soviet Union's existence, walking within sight of the Kremlin with a friend, an Azerbaijanian chemist. His answer stunned me.

I thought, someone is finally telling the truth, he said.

What?! I thought. The liberals in Washington, D.C. where I grew up were generally aghast when Reagan called the Soviet Union evil, labeling him a war monger. That day in Moscow I learned how different the same thing can look to different people.

Ahead of July 1 commemorations celebrating the Chinese Communist Party's 100th anniversary, this is still true. Among foreigners, antipathy toward China has never been higher, based on Pew polling. On the other hand, inside China support for the Party appears high. Different people see things differently.

The chart below that my friends at Rose created succinctly shares one perspective.

Over the last decades, compared to the US, in China you are less likely to be murdered and more likely to make money. Both relative to the experience of other countries and the volatility China itself experienced before this—Cultural Revolution, starvation, Mao's cult of personality—the Party's support makes sense.

For those of you who don't know about the Cultural Revolution, I can't recommend highly enough listening to both Part 1 and Part 2 of my interview with Gao Xiqing. His name may mean nothing to you, but in China he is a big deal and it is rare to get someone of his stature to describe what this experience was like.

Under Xi, China's economic boom has been accompanied by increasingly bellicose foreign policy. Moreover, like many one-party states, contemporary China is marred by both corruption, according to polls by Transparency International, and weak rule of law, exemplified by President Xi obviating term limits.

Despite today's obvious tension between China and the US over issues like Hong Kong and Taiwan, the two countries are more similar and linked than they were 50 or 100 years ago. In 1971, Mao was advocating Cultural Revolution while the US fought a deeply unpopular war in the mistaken belief that Vietnam's politics would spread to Southeast Asia. One hundred years ago, the US economy was in the grips of the Great Depression and China a civil war.

Trade links are also substantial. The US exports tens of billions of dollars of airplanes, cars, soybeans and cotton to China and imports a lot of the things that are in your house or apartment—furniture, appliances and sports equipment. This does not show any sign of substantially shifting, absent specific sectors like cutting edge technology.

That gradual narrowing of differences is also evident in both the economy and economic policy. Both economies must deal with disruptive climate changes. Both economies are dependent on technology to boost future productivity and competitive capital markets to help fund this innovation.

Regarding policy, it used to be monetary and fiscal policy worked in tandem in China and independently in the US. Now that line in the US is increasingly blurred. In an example of the US moving toward China, the US is now mixing fiscal (spending) and monetary (printing) policy.

How things unfold from here is tightly tied to how well each region manages coming disruptive technological change. While the CCP has both unified China and led a massive economic boom, it did so in part by catching up on 150 years of under-investment. Now Chinese roads, airports and bridges look better, to my eye, than those where I live in New England.

Going forward, different challenges await. For each economy to prosper, millions of peoples' jobs will be obliterated by technology. They will need to find new occupations, even as automation further narrows the gap between human and machine. To grow, economies must change, which creates instability.

It is the wreckage from this creative destruction process that in part led to the rise of Trumpism. A swath of the US population is frustrated enough that they are willing to overthrow the government. This reality in turn motivated the Biden Administration to undertake the most aggressive fiscal action since FDR, an effort to demonstrate to a country increasingly riven by an urban-rural divide that the government can solve problems.

The test for China's leadership is also acute. As Chinese policy officials themselves have indicated, growth can no longer be fueled by infrastructure and debt. As the US and Europe have learned, confidence in the government is dependent on growth. The CCP will have to navigate this coming period of economic change by both rewarding disorderly technological innovation and at the same time maintaining strict control. Unlike with China's catch-up period of growth, this time there is no template.

A Covid Hangover

When I was an adult, I asked my father—a tall, lean man with a shock of white hair—how he invested money when I was a kid. His answer was simple: he didn't. In part, this was probably because the markets didn't interest him. In part, I suspect this was because he grew up during the Great Depression. For him, stocks losing 90% of their value wasn't an aberration, it was life.

The point: the economic and psychological consequences of big shocks can last.

It's hard to realize the Covid shock is of similar magnitude—almost 4 million dead—to other major historical shocks. Sometimes Covid doesn't feel significant. I spent most of the pandemic in a suburban house. No one can say with precision what the Covid aftershocks will be. I do, however, suspect that trying to predict the recovery via classic economic analysis won't work well because such models don't factor in psychological shifts.

A bit of context (skip if you are a markets person). Economies tend to grow over time. When they grow very quickly, shortages develop and prices rise, which is called inflation. When they grow slowly surpluses develop, which causes deflation. Inflation shifts have a big impact on your wealth and, ultimately, happiness, a bit like how small shifts in the globe's temperature have big impacts on the weather. When inflation increases quickly, your ability to buy things goes down. When this happens, typically (not always) central banks reduce the amount of money they are printing and this change then causes the assets you likely own, like stocks and real estate, to lose value.

On Wall Street, there is general agreement the economy will pick up and sharp disagreement about inflation. Those who believe we will get inflation are looking at Covid as a classic economic shock. We spent less, soon we will spend more, there will be additional fiscal stimulus and, presto, the economy will be growing so quickly we get inflation that is more than a quick burst.

That could happen. However, when I look at shocks I've witnessed first-hand, it seems to me they operate more like how my father did; there is an accompanying, sometimes counter-intuitive, psychological shock that impacts the economy and sometimes politics, too. A few examples.

a) The 2008 credit crisis. In its wake, a generation shifted their attitude toward the attractiveness of home ownership. This didn't make rational sense. Home prices fell so it was attractive to buy.

b) 9/11. The day after, I recall watching fighter jets patrol the skies like angry wasps. Congress signed off on wars costing $6 trillion dollars, a massive capital misallocation relative to making investments in domestic infrastructure and education that could have boosted US productivity.

c) The collapse of Soviet Communism. Rather than lead to a global opening up, it eventually led to a turning in. Moscow and Beijing focused more on the subsequent fall in Russian living standards and life expectancy than the benefits of what proved to be a temporary expansion of civil liberties.

In the data, there are signs of a similar psychological shift this time. No one data point is predicative, the cluster suggestive. This makes sense. Our wiring hasn't changed. Disruption changes us.

Elevated savings rates. Savings rates, how much of each dollar is spent versus saved, have risen above average. It may reflect stimulus checks, it may also reflect a recognition that life is uncertain.

China's muted recovery. China has been ahead; it got the virus first, locked down more strictly and got out first. Yet, the recovery there has been modest, which recent forward-looking data shows. Of course, Beijing has not been nearly as stimulative as the US, so this is also likely muting China's recovery.

Tepid travel recovery. For every $100 spent in the global economy, about $8-$10 of it comes from travel and tourism. Yes, only about 20% of the world is vaccinated and travel restrictions exist, but perhaps there is simply more caution about being far from home, as the chart from Rose illustrates so well below.

Financial markets. Financial markets are not reliably predictive. That said, the bond market continues to predict weak growth.

In short, there are hints Covid is leading to behavior shifts, a bit like what happened with my father. By the way, his investment strategy was a mistake. He was applying a lesson learned in the 1930s to a very different reality.

Shifts in economics can in turn drive politics. Beyond economic caution, could Covid also make us more tribal? There is now a class of monied worker whose income is no longer tied to a specific community or workplace. The gap between these people—nomadic algorithm writers—and less educated, anti-vaxers is already a chasm and may widen yet further. That's not good for political stability. At the same time, cracking down on tech monopolies to narrow this gap seems risky. How would we have survived Covid without Amazon?

In response to all this, I have modestly shifted my asset allocation—I've reduced the size of my hedges against a rapid Fed tightening and own a bit more stocks (though this letter is not investment advice).

Discontent

I'm thinking Canada, he said, looking up to judge my reaction.

It was an early morning breakfast at a diner off route 95. We faced neither food shortages nor violence. His parents had emigrated to the US from India fifty years ago; now he was considering leaving.

It was the second time I've had such a conversation recently, each one a flicker of fear. Of what exactly? If history is a guide, approaching violence and wealth destruction. So far, the flow is decidedly in the opposite direction. In 2019, 10,000 Americans emigrated to Canada, less than 0.1% of the US population, while more than a million people became US citizens.

Humans recognize deviation from patterns, like a sudden shift in wind that presages a summer storm. How vigilant people are varies. Some only notice when the wind is howling, some sense small shifts. Those groups that have experienced disruption in the recent past are likely more attuned.

The ideas that govern most Western countries date to the Enlightenment and center on human fallibility and the primacy of law to reinforce logic over emotion. Right now, people in many countries are simultaneously exhibiting just the opposite, a surge in emotion. The US, Poland, Hungary, Turkey, Russia, France, Brazil, India and China come to mind.

In the US, based on polling, the right believes the US presidential election was stolen (53%), Covid vaccines are a bad idea (43%) and the media is untrustworthy (90%). The left believes work ethic doesn't relate to economic outcomes (80%). Most college students now self-censor (60%) despite widespread (90%) belief in free speech.

Said differently, significant parts of the population don't believe in the integrity of elections, science, journalism or higher education. At the same time, party affiliation is weakening. Only around 30% of polled voters consider themselves left or right. About 40% identify now as independent.

No one knows for sure why this is occurring. That said, technology shifts that simultaneously disrupt income and information likely play a central role. Take media. This post you are reading reflects this very process. When I grew up, there were essentially three television stations and one newspaper, *The Washington Post*, which made so much money Warren Buffet bought into it. No more. We live in an informational whirlwind.

This change delights and distresses at once, amplifying both uncertainty and choice while accentuating the ancient tension between those who distrust change and those that embrace it. Conservatives favor preserving institutions, liberals in reforming them. The question is what is the acceptable rate of evolution.

As tensions build, systems either bend or break. The US has had a lot of bending—around Vietnam and Civil Rights and the Great Depression—and one near break, the Civil War. The economic swings in these periods were enormous. Stocks fell 90% in the Depression and inflation rose to 14% in the 1970s. Yet, wealth was never completely wiped out via asset seizures or hyper inflation and the basic system of government remained intact.

Big financial disruptions come when systems break, like Germany (1933 and 21-23), Russia (1917) and China (1912). The template was France (1789-99). The French Revolution was protracted, even as the rules they codified continue to be, more or less, the terms by which Western Democracies function. France lurched between left and right, accompanied by bloodletting against the highest members of government, financial chaos and a military coup. The chart below from Rose Technology shows what this looked like. Imagine this happening to the dollar.

In the US, the recent surge in emotion has resulted in limited violence, an attack on the Capital and significant shifts in economic policy. The Fed's more lax stance toward inflation and Biden's fiscal plans are well-intentioned efforts to rectify imbalances and restore confidence in government. So far, this looks like a bend, not a break.

Yet, the levers are tricky. Take monetary policy. Once the money is printed it is often difficult to target exactly where it goes. Inflation fueled by rising wages would help the poor; inflation led by commodities, particularly food, would hurt them. Fiscal policy (spending and taxes) allows more targeted spending but is also a more political process, which is why negotiations over infrastructure spending drag.

The House of Representatives gives weight to population centers—cities—which tend to be more liberal. The Senate gives disproportionate weight to the rural areas, which tend to be more conservative. Some of today's divisions echo those in the past. The two states with the lowest vaccination rates—Alabama and Mississippi—had the highest percent of their population that were slaves (45% and 55%) and the Confederacy was created in Montgomery.

So far, I continue to bet on a robust US and global recovery, largely by being overweight assets that favor strong growth like stocks and commodities. I maintain hedges in case the Fed starts to print less money. I own bonds, but they are all foreign. While I own foreign currencies, most of my wealth is in dollars. I don't own bitcoin. If there are signs of a break—rule of law in the US being eroded— expect disorderly asset flight, meaning a selling of dollar assets and a buying of foreign ones. If it comes to that, I plan on doing the same.

Our Stock Market Addiction

Dude, everyone is doing it, just re-register your company as an C-Corp and put out the call for money. In this environment, why not?

I was speaking with an entrepreneur. He has a disruptive idea backed by venture money. Before a company goes public, there is an eco-system of lenders who fund early-stage companies in the low odds hope one of them will become the next Apple. (My company, Still Press, is an LLC). The higher stock prices rise, the more willingness there is to bet on early-stage ideas. This now looks excessive.

Many things are magical in moderation and terrible in excess. Alcohol, food, exercise and work can all become addictive. **Addictions organize reality, create drama, make us want more and spread wreckage**. The stock market now meets this standard.

In terms of economic policy, the stock market is now having an outsize impact.

Some context (finance people skip). Financial folk focus on prices, cotton prices relative to Apple stock, buy low and sell high. The process that sets each price is intricate, passing through many pipes and spigots, though ultimately the money comes from just one place, the central bank.

Stocks typically crash when prices are high and conditions shift quickly, often pre-ceded by a reduction in money printing. Almost no one likes it when stocks crash. Everyone who owns a stock gets poorer. No Fed chief wants their name associated with a big crash, the way President Herbert Hoover's name is associated with the 1929 crash. As a result of both the economic impact and, I suspect, reputation legacy, in recent decades each Fed chief has been quick to act when stocks fell sharply in 1987, 2000, 2008 and 2020.

They stop a crash by printing money. When printed money goes into the economy it creates inflation. When printed money goes into stocks it creates a bull market.

Because we have had repeated crises, we have had repeated easings. Interest rates, now zero, are the cost of money, meaning borrowing money is free. The price of one—stocks—is tied to the price of the other—money.

Going forward, we are in a delicate spot. Many (but not all) measures of US stock prices (none of them precise) suggest the US stock market is very expensive relative to average. The very success of past money printing has increased household sensitivity to the stock market going forward, though some people own more stocks and some less. While I don't see an obvious catalyst in the short-term, I also recognize even a modest money printing reduction could have an outsize effect, driving stocks sharply lower.

In terms of business, the stock market is creating powerful incentives. When you start a business, the big challenge is cash flow. You have an idea but no profits. A loan is onerous. If the new business fails (and most do) the entrepreneur is still the hook for the debt. No bueno. If you issue a stock and the company fails, the entrepreneur owes nothing.

Today's stock frenzy is a bonanza for start-ups. If everyone wants to buy a stock, why not issue it? Of course, this process funded many incredible companies. The software I am writing this with, the computer I use, the high-speed connection, etc. are all a part of this dynamic. But with the stock market and stock options this frothy, it creates an incentive structure that makes it hard to discriminate a good business from bad and sucks talent into any sector that can issue stock, even if that is not a good use of society's limited talent resources.

Yes, central banks have good short-term reasons for printing. We are in a pandemic; more refined estimates suggest more than 10 million dead! If now isn't an emergency, what is? But this policy comes with collateral damage.

Entertainment is another element of the addiction. Multiple cable TV stations make their money by reporting breathlessly on what is happening with the market. If you think about it, it's odd. The stock market helps companies, which might last a generation each, to raise money. Why update it like a tennis match? Retail Apps that allow for even faster trading of stocks further turn the process into a game.

In terms wreckage, we are living in a massive asset values run up. The next generation needs to buy these assets from us, the people that own them. The prospect for the return of doing so likely is not good. This quixotic chart below puts this in perspective, our generation is just a moment in time. See my post, Letter to a Young Person, for thoughts about what to do.

This stock frenzy will either ebb or crash when the Fed reduces the money they are printing. Maybe we just go sideways as opposed to down. In any case, that is an issue for 2022 and 2023. I'm long stocks as part of my asset allocation, but only hold about 10%-15% of them in the US and I maintain hedges in my portfolio to help reduce the pain when the Fed eventually shifts behavior.

A Woman's World

There is nothing more natural than having babies. Sitting at a desk in a public library, I watched about 30 of the next generation wobble uncertainly on the grass, shaded by tall trees. "You put your left foot out…," they sang, a young parents' group from the look of it or, more accurately, mostly a young mother's group since there was just one man.

Biden's latest infrastructure plan contains provisions that, in essence, make it easier to have babies and work. What economists call women's "labor force participation" is lower in the US than in other rich countries, as the chart from Rose Technology shows below. While the bill is portrayed in the media as a left and right dog fight, when I look at what information exists, the proposals look terribly unambitious if the goal is to raise more resilient, productive children.

I write from the perspective of both a parent and investor. As an investor, a key thing is to size your bets. You can have a great idea but if you only put a tiny amount of money on it, the bet doesn't meaningfully impact the final result. For perspective, the US Federal Budget was $6.6 trillion in 2020. For every $1 the US Federal government spent, about 10 cents went to the military and 11 cents to medical insurance for older people. Biden's family plan would get less than half a cent.

Since leaving Wall Street last year, one of the most surprising things I've discovered is what I will describe as a women's world. In finance, women in senior ranks were rare. When I was there, I never wondered where the women were. Now that I spend my time writing in coffee shops, beaches, libraries, New York City parks and surf breaks I found out—many are taking care of kids.

I had assumed women weren't in senior roles because the men who played a role in selecting executive cadres were biased. I still think that's true, even if the bias is subtle. The terms I suspect many associate, in a cartoonish way, with a senior finance professional—like "gravitas," "seasoned," or "workhorse"—perhaps attach more readily to the image of a middle-aged guy with a paunch than a younger woman with an emerging baby bump. A number of the senior women I saw up close who had families also happened to be amateur endurance athletes, which was instructive given how much they were juggling.

That said, I now suspect additional forces are at work. One of them is the window dictated by fertility and the desire of many women to spend time with their children, particularly when they are young, though exactly how much and in what configuration is highly individual. I also look at kids playing with a parent through the prism I shared in my book Raising a Thief. The seeds of curiosity, resilience and conscience are planted in the very earliest years (0-3) and are highly contingent on a child having an firm bond with their primary caregiver, a concept called attachment. When this bond is fractured, chaos ensues that can be impossible to repair.

Larry Summers, the former President of Harvard, lost his post for suggesting that something in addition to sexism may be at work in women's professional status. "The data will, I am confident, reveal that Catholics are substantially underrepresented in investment banking … that white men are very substantially underrepresented in the National Basketball Association; and that Jews are very substantially underrepresented in farming…"). Yet, in the speech Summers never explicitly spoke about the very human, perhaps the most human, desire to have a baby.

Biden's "infrastructure" bill attempts to shift this dynamic. The bill is indeed about traditional infrastructure (see my post The Case for US Infrastructure for more about the state of our bridges, which are literally falling down). But there is also a plan to allocate money to families. Given that Bernie Sanders is chair of the Senate budget committee, I suspect many independents and Republicans might think something radical is afoot. As far as I can discern, the basic idea is to a) guarantee a certain amount of paid time off to new parents b) guarantee quality, universal child-care when the parents go back to work and c) make sure kids have enough to eat.

Specifically, the plan guarantees new parents 12 weeks off after a kid is born. Three months is hardly socialism. In Germany, by contrast, a mother can take up to three years off, which, while it may sound radical to an American, makes much more sense in terms of a child's attachment. To be sure, such a shift does bring the US closer to global norms, as you can see below.

The US does sometimes make big bets. Trying to export Democracy to Iraq and Afghanistan cost $6 trillion. In retrospect, a terrible bet. Now the pendulum is swinging hard the other direction, toward bridges and babies. But the Administration's scaling of these bets seems off. The program I know that seems most reasonable and tested at shifting children's outcomes is the Harlem Children's Zone run by Geoffrey Canada. My back of the envelop calculations (which are not precise) suggest that if the US were to apply his model more broadly it would cost more like $1 trillion over 10 years, 5x what Biden is proposing.

In terms of investing, I have increased my exposure to risky assets in recent weeks and have reduced the size of my hedges to Fed tightening given that the Delta variant now means the hazy period of Covid hangover will last for longer than I had thought a few months ago. I think it is possible that we get another severe Covid spike in the fourth-quarter as evidence emerges that the efficacy of vaccines fades, so I am as worried about Fed tightening as I am new restrictions on movement and have added hedges in my portfolio for that risk as well (though this is NOT investment advice). The central trend though is a fiscal fueled reflation and that's where the bulk of my risk is.

China Context

For foreigners, particularly Americans, it's hard to make sense of Chinese policy because the systems are so different. This is evident in the reaction to Chinese regulators' decision to defenestrate private Chinese education companies. A representative sample from Bloomberg: "after a week of wild market swings and tense calls with clients, some investors have decided China just isn't worth the trouble." For the record, China's stock market is up 27% since Jan. 1, 2020 and down 7% this year. With that in mind, some context.

1. While the US and Chinese administrative systems are very different, many problems they face are similar, like global warming, disruptive tech change, large gaps between rich and poor, an information revolution that changes both what information is created and how it is disseminated. Other issues, like demographics, are different.
2. **China has a potentate, Confucian values, modern technology, Soviet political software and language**. The US has separation of power, Judeo-Christian values, modern technology and Enlightenment (17th century) political software and language.

3. While **many Americans and Europeans find the Chinese system bizarre**, it is not likely to change any time soon. Parts of the system are thousands of years old, including the language, culture and notion of a supreme leader.

4. For perspective, **many Chinese find parts of the US system bizarre**. Why, they wonder, can mentally ill people obtain high powered rifles and shoot children? What about the power afforded to anti-vaxers? What kind of political system produces repeated economic crises (2000, 2008 and 2020) and Trump?

5. If you want to see the different systems in action you can now read Chinese newspapers and have them instantly translated. Friday, the *People's Daily* asserted "under the strong leadership of the Party Central Committee with Comrade Xi Jinping at its core we have coordinated the overall situation at home and abroad…". Message: everything is under control. On the same day, *The New York Times* said, "CDC Internal Report Calls Delta Variant as Contagious as Chickenpox." Message: things are almost out of control.

6. Distinguish between the people and the government. There are Chinese people in Taiwan and Chinese people in mainland China and the systems of government are very different. The Chinese people I know are hard-working, thoughtful, honest, curious and loyal friends.

7. A potentate, like Xi, has a degree of power unimaginable in the US. If the supreme leader has good ideas, this can lead to very rapid improvement. If they have bad ideas, the opposite.

8. Until 1912, China had an emperor. While there were different dynasties, this system went back a long time. The first modern potentate was Mao. He unified China after decades of civil war and invasion, a huge accomplishment. He also enacted policies that led to mass starvation and a decade of chaos during the Cultural Revolution. (The picture accompanying this post is one I took in Western China detailing food rations).

9. The next modern supreme leader was Deng. Way ahead of the collapse of the Soviet Union, he introduced capitalism, while retaining authoritarian control, leading to the biggest economic boom ever, anywhere. Hundreds of millions of people were lifted out of poverty.

10. After Deng stepped down, a number of potentates followed. All, more or less, stuck with Deng's policy.

11. Xi came to power in 2012. **The essence of his rule is “going back”** to, in his eyes, go forward. If the pendulum in China has swung from Mao (hard core communism) to Deng (authoritarian political control with hyper-competitive private sector capitalism), Xi is moving the pendulum back, more control, less free market.

12.In the US, the pendulum is also swinging back, thus the appointment of anti-trust academic Lina Kahn to run the Federal Trade Commission.

13. A pendulum swing doesn’t mean Capitalism is dead. **The Chinese have studied the collapse of the Soviet Union in detail and know command economies don’t work.** Economic theorists in China talk about finding a “third way,” something with features of capitalism and communism. However, a swing back does mean no term limits on the potentate, crushing Hong Kong and more overt threats to forcibly integrate Taiwan.

14. With that context, last week’s regulations make more sense because:

a.   All households are exposed to shelter, education and medicine. In all countries trying to figure out how to allocate these resources equitably is tricky. Think about the US debates over affordable housing.

b.   Chinese culture places a strong premium on education. Learning the 6 or 7 thousand characters required to graduate high school takes enormous work and more attention has recently been placed on developing the “whole child” as opposed to endless cram sessions.

c.   Private education courses are expensive. The expense of raising a child is cited as a factor in China’s low birth rate, which China is now trying to shift.

That said, the suddenness of the policy shift, which essentially wiped out education companies overnight, speaks to either a more chaotic policy making environment or a swift shift of view by the supreme leader or maybe both.

I still find Chinese stocks attractive and hold some in my portfolio. They are cheaper than US stocks, represent some innovative companies and are diversifying to what I already own. However, I don’t hold the stock market index, the Chinese equivalent of the S&P 500. Chinese authorities may crack down on other stocks and US authorities may prohibit the purchase of stocks tied to the military or high-tech. **I believe China’s stock market is a “stock pickers” market.** I am not a stock picker so I’ve hired people to do this. THIS IS NOT INVESTMENT ADVICE, more ideas for discussion.

The Talent Skedaddle

You thinking of leaving? I asked.

I am, he said, looking away thoughtfully.

I was speaking with a Russian CEO on a sun-drenched porch in Istria, Croatia, not far from Slovenia and Italy. The translucent Adriatic sparkled nearby. He was wondering aloud if the Baltics, where he is now based, is far enough away to keep him safe from Moscow's reach.

The Kremlin's heavy hand is once again scaring off talent, a long-standing tradition. One of my great grandfathers made a similar calculation over 100 years ago and quit Russia for Chicago. Abandoning a country is wrenching. It typically takes several generations for a family to regain its footing. The talent drain also puts those countries that suffer from it at a structural disadvantage.

People skedaddle when they don't feel safe and sense better opportunity elsewhere. Tracking this data provides an additional lens on both politics and markets. The data suggests that what investors refer to as "emerging markets" are seeing consistent people outflows in favor of developed markets.

That is unfolding even as dysfunction in developed markets is disconcertingly obvious. Pick your image—retreat from Kabul, bellowing anti-vaxers, storming the Capital, protest cities in flames, ballot recounts. Yet, as the chart below from Rose Technology shows, people are voting with their feet and looking past these concerns.

Russia shows up on both sides; people in Kazakstan and Uzbekistan find Russia comparatively attractive even as the educated Russian urban elite leaves. Saudi Arabia is reliant on immigrant labor from, among other places, Bangladesh.

Of the roughly 20 Russians I interacted with in Istria, over half hold foreign passports. The most recent twist that caught their attention is the Kremlin's decision to label the independent media outlet "Rain" a foreign agent. Just as America can be divided into Trumpists and anti-Trumpers, Russia can be divided into the "Crimea Ours" camp (Crim Nash in Russian) who celebrate Putin's Crimean seizure and those who are appalled by it. The "Crim Nash" group is in charge. China's recent calls to focus on "common prosperity" are similarly ringing investor alarm bells.

Power and wealth are always in flux and the search for hospitable conditions is ancient. The Croatian town I am in has been claimed by Greeks, Goths, Romans, Venetians, Hapsburgs, Austrians, Italians and until relatively recently was part of Yugoslavia. We are animals and crave safety, particularly when we reproduce. As one Muscovite told me, “I worry not so much for myself, but for my kids.”

Most investors look at prices, not migratory data. From that perspective emerging markets like Russia and China are “cheap,” meaning what I’ve described above is already priced in. In fact, some investors currently believe these markets are too cheap. Increasingly, I am not so sure. I like to put the price of all assets in yield terms, which allows easy comparison across stocks, bonds, real estate, etc. The current yield of the US stock market is around 3%. The yield on Russian and Chinese stocks is double that. Said differently, investors demand a higher return on capital to accept the risks of these markets. The question is whether this higher yield adequately compensates an investor for the risk.

While investing in emerging markets is hundreds of years old, the idea got a big push when the Soviet Union collapsed thirty years ago. Seemingly, this event ended one of the 20th century’s great policy debates decidedly in the direction of free markets. New capital markets opened up and investors envisaged markets that could provide both a positive return and diversification.

Yet, the question over the optimal political structure remained, largely between what Karl Popper (George Soros’s teacher) described as “open” or “closed” societies. Popper traced the debate back to Plato, who put more faith in rule by an enlightened few as opposed to giving the masses a say. Now these closed authoritarian structures appear to be tightening their grip in a way that is negatively impacting asset pricing and prioritizing domestic politics over capital markets.

I want to believe that open, flexible systems will prevail. The Russians I was with seemed to be largely making the same bet. At the same time, no one has ever tried to administer populations of this scale. When the US was founded, the population was roughly 4 million and of those only about 25% could vote. I’ve allocated a modest part of my portfolio to emerging markets. I need to think about it a bit more, but going forward this emerging market allocation may become even smaller even though the developed markets are, as traders say, expensive.

Moral Man, Amoral Markets

Come on man, we are surrounding the administration building, let's go, said a guy with curly hair in a jeans jacket.

I was sitting on a college green. As I recall, it was a crisp fall day in 1986 in Providence, Rhode Island. I was a freshman.

What for? I asked.

To get them out of South Africa.

Thus began my first interaction with what has come to be known as "impact" investing, the notion that one should weigh ethical considerations in investment decisions. The jeans jacket guy was referring to the university's endowment.

In different ways, this idea continues to ripple through financial markets. Last month, Bloomberg reported that ESG—Environmental Social and Governance investing—had reached $50 trillion in assets; last week, news outlets reported that credit card companies sought to distance themselves from the Only Fans website due to reputational concerns. Earlier this year, US government officials discouraged investors from holding bonds from US rivals, like Russia. Different flavors, same idea.

Ethics are the glue that encourage us to act from our better selves. In open societies, they are also reflected in a political process where these notions translate into rules we agree to live by. It was this process that led to substantial (and obviously overdue) legislative shifts like outlawing slavery in 1865 or the Civil Rights Act of 1964. The political process is arduous in part because notions of good and bad are both unstable and debatable, meaning the vision of the idealized society we are striving toward evolves. **Impact investing is to supposed to hasten this journey, which sounds alluringly noble but in practice may well lead to *worse* outcomes**.

Unlike politics, investing has measurable goals. Over time, the goal is to channel current savings into productive future investments. This is measured by productivity, or output per person. The goal of capital markets is to price this resource allocation. **From an investor perspective, the goal is to grow money as much as possible while enduring the lowest possible risk of loss.** This ratio of return to risk is how investment managers measure themselves.

The higher the ratio, the better the result. Think of this ratio like miles per gallon. I've tracked my ratio over time. While the majority of my investment ideas work out, some don't. I get a lot of things wrong. This is normal, but I don't want to make the game harder than it already is by adding additional complexity.

Predicting return and risk is difficult, almost impossible. A pandemic comes along and predictions turn out to be wildly off. Companies that were thought to be relatively safe, like airplane or hotel companies, suddenly become risky. The list of disruptions is long—pandemics, new technologies, wars, financial crises, etc. This is why I try to keep my investment assumptions, like diet guidelines, very simple, as I've explained previously.

Impact investing introduces a third variable. With regards to ESG, there is a complex rating methodology for each asset. Embedded within the rating system is the political question cited earlier, our vision of an idealized future. Given how hard it is to get the first two variables—risk and return—right, I am skeptical adding a third variable that purports to accurately calculate the relative ethical impact of a tobacco company to an oil company will help.

Moreover, if I exclude certain assets from the potential pool of investments, which is what that protestor was arguing for in 1986, several things happen at once. First, I lose the ability to influence an outcome, like using share ownership to encourage a company to shift hiring practices. Second, **I impair my ability to create a diversified portfolio**, leading to higher risk portfolio concentrated in certain sectors. Third, I may incur higher fees. Fourth, I impair the ability to distill market pricing.

This last element is likely esoteric for non-investment people, but it is important. Financial markets offer perspective on what investors believe the future course of growth, inflation, credit risks and other measures will be. Policy makers, like the central bank, use this information to adjust course. Withdrawing from markets, like forbidding investors to hold Chinese or Russian bonds, undermines this process.

I have other questions. If we are truly concerned about, say, the environment, isn't the best thing to simply consume less? That's terrible for the stock market and impactful for the environment. If there are things I am missing, I genuinely look forward to readers educating me. For now, impact investing isn't part of my strategy. In terms of my asset allocation, I continue to be long stocks, raw materials and bonds outside the US. I still have hedges against Fed rate hikes, but they are smaller than they once were.

Speeches That Resonate, Forever

Things I Didn't Learn in School is about both the macro—what is going on in economies and markets—and the micro, individual life stories. If macro is the cathedral, micro is the stone, both matter. For the latter, I find the podcast to be an ideal forum and today release our third season. We plan to air episodes every two weeks this fall and have, as they say, a great line-up.

Today's podcast is a conversation with Adam Frankel, one of the key members of President Obama's speechwriting team and a fellow memoir writer. You can hear the conversation by clicking this link. The show is also available on Apple, Spotify, my website and other major podcasting outlets. As always, if you enjoy these talks, please rate them on Apple Podcasts, that helps draw other listeners in.

I am a bit of a political speech junkie. There was a point in my career where I did a lot of public speaking. To improve, I studied the greats. While most political talks make me cringe, some transcend. Like good art, they both inspire and put into words what people are thinking but struggle to say. Personal favorites include Winston Churchill's speech in the dark days of World War II ("I have nothing to offer you but blood, toil, tears and sweat"), Martin Luther King's haunting speech just days before his murder ("mine eyes have seen the glory…") and a number of Obama's that, whatever your political sympathies, are masterful. Adam and I discuss a few examples in our conversation.

An expert on public speaking once told me a good speech hits four levels at once: kinesthetic, digital, audio and visual. Kinesthetic is how you feel as you listen, digital is the facts and figures cited, audio is how it sounds, like the tone of voice, and visual is what images are conveyed. This expert said most speakers can only hit a few of these languages at once, the greats hit all four.

This Sunday I am going to send out a note about … money. Not economics and markets, although there is a lot going on, but money in regards to these notes and podcasts. More later. Thank you for your interest!

Labor

If you read these posts regularly, forward them and download the podcast, I am making a request—become a paid subscriber or a sponsor. I think you now have a sense of what we are up to. Below, I'll tell you a bit of where we would like to go.

I had two ideas when I started *Things I Didn't Learn in School.* First, I found many smart, non-finance friends had trouble making sense of economics, markets and investing. Topics like interest zero rates or the rise of China influenced their lives but confused them. Second, after writing a memoir, readers shared their stories with me. Lightbulb moment—the big macro throws shadows around our micro dramas; I wanted to zoom out and in and show when one related to the other written in jargon-free language.

In China Context I wrote about the Cultural Revolution. In the podcast, Gao Xiqing, describes living through it. In All Companies Die I wrote about economic disruption. In the podcast, photographer Paul Fetters describes the death of film and the birth of digital. Letter to A Younger person is in part about growing up without money, which relates to my conversation with Eileen Murray.

I am mindful we are in an information maelstrom. When I grew up, information came twice a day; *The Washington Post* in the morning (my brother and I delivered it) and the evening news with Walter Cronkite. Now the CBS evening news gets less viewers than a strong Twitter Account. I don't want to make the maelstrom worse.

I can't do this alone. I rely on a small band of either volunteers or those on starvation wages; Dave for the podcast and general wisdom, Anna for graphics, Carly for social media, proofreaders. I could also use a copy editor and economic analyst. When Covid eases, I'd really like to take this work abroad and do reports/interviews from there. I am asking you, in a way, to join the band.

Down the road I will likely more firmly delineate the distinction between paid and free. Paid will likely get:

- my asset allocation quarterly
- foreign policy posts
- exclusive podcast take-aways
- office hours.

For now, if you like this work, put a price on it. A monthly subscription equals two lattes a month, $7. Founding members would make a big difference. For those that have recently signed up, watch what comes out in the next few months and make your own assessment a bit later. Happy Labor Day.

Betting on Human Nature

Assuming economic actors are rational…, droned the Professor.

It was 1995. I was in graduate school studying economics. He was a teacher out of central casting—brown tweed blazer, tan khakis, trim beard. Intuitively, I thought rationality was a dumb assumption though at the time I lacked evidence to provide a rebuttal.

Now, however, it's very clear many human beings struggle mightily to think in terms of reason and probability, which has significant implications for both investments and politics.

The consensus around how logical we are has gradually shifted. In 2002, Daniel Kahneman won a Nobel prize for injecting psychology into economics. He assembled data that ingenously illustrated bias. My favorite anecdote from his book Thinking Fast, Thinking Slow is that the odds of being granted parole by an Israeli judge spikes markedly after meals and sinks before them. The 2008 credit crisis was an additional marker. Former Fed Chairman Alan Greenspan confessed to being flabbergasted at how short-sighted banks were about extending loans. In an interview, Greenspan admitted losing faith with "the presumption of neo-classical economics that people act in self-interest."

COVID should eliminate any remaining doubts. The US is giving away miracle vaccines and tens of millions of eligible people are not vaccinated. Vaccination rates are even lower in other countries. In Russia, just 27% of the population is vaccinated! (We are airing a podcast with a Moscow doctor in the midst of this challenge soon).

A Covid shot can be thought of as insurance policy against a low likelihood but terrible outcome, death, that has directly impacted around 7 to 8 million people (judged by excess mortality). Like Kahneman's experiments, Covid illustrates millions of people won't act rationally. In terms of investing, a lack of rational behavior has implications for both the merits of diversification and how to factor in climate change.

Diversification is in part an insurance policy against irrational people buying or selling the assets you own. Markets — real estate, stocks, bonds, bitcoin — price relative to each other. If the price of an asset rises, the yield falls. In response to the pandemic, the government bought bonds, driving their price up, yields down. As a result, money left the bond market and poured into other markets, leaving some prices improbably high including, for some readers, the stock of the tech company they work at.

Professional short sellers are investors that target what they deem to be expensive assets, like Tesla, and make money when prices fall. Famous short sellers like Mike Burry (of The Big Short fame) and Jim Chanos are supposedly short Tesla and likely frustrated that the stock, priced equivalent to 15 Fords, is gaining in value, as the chart from Rose Technology below illustrates. Tesla is in the S&P 500, meaning if you have savings you are likely exposed. The point: spread your bets.

Second, given human biases, it now seems reasonable to bet policy makers won't fix climate change, which is significantly more complicated to visualize than Covid. While I hope I am wrong and will vote for candidates with appropriate policies, I expect that in the coming years the earth will become hotter, sea levels rise and the violent weather we are witnessing will becomes even more violent. The below chart, again by Rose, shows a range of outcomes for shifts in the sea level based on something called RCP8.5, which is that no substantial change in behavior occurs. Note the wide range of potential outcomes.

Rising sea levels will flood population centers on the sea, like Shanghai or New York. The below chart illustrates what a 2 meter rise in water might look like, the mid-point of the range. I am not a climate change expert, the mid-point looked like a reasonable place to start.

As with Covid, this shift will be enormously and tragically disruptive to many peoples' lives. But just as with Covid, rich countries will spend money to blunt bad outcomes. In terms of investments, it leads me to want to own things like air conditioning (which requires copper and aluminum) and sea walls (which require steel and concrete). A basket of these stocks (producers of steel, aluminum, copper, concrete) has already risen quite a bit, though this is more due to the prices of copper and aluminum rising than concrete. (Full disclosure, I own these securities). It seems to me it may rise further (though this isn't investment advice).

Looming over this is a political question. How much can we trust the good sense of the common person? That question is complex enough to justify a separate essay. Suffice to say Authoritarianism's answer is "no" and Democracy's answer is "yes." At last count, 63% of the eligible, above 12, US population was vaccinated. Maybe that is as rational as we get.

A Framework and Soros

I was sitting on a plastic chair drinking a coffee, staring at a brown river and taking in the last days of summer.

A Things I Didn't Learn in School subscriber sat opposite and asked a deceptively simple question.

I'm reading your posts, he said, if you boil it all down, what's the take-away?

Good question. That's one reason I like writing. It creates quality dialogue. My answer is that we are in a bit of a lull. The forces driving stocks, bonds and house prices up are beginning to recede but only ever so slightly. There are very significant risks on the horizon, but so far they are not imminent.

However, the question triggered two reflections. First, these posts talk about pieces of the puzzle, like inflation or geopolitical shifts, but so far I have not shared an overall synthesis. Second, perhaps more useful than any synthesis, which will evolve, is the framework I use to generate a synthesis, which is what I will share today. In the follow up post next week, I will apply the framework to current conditions.

The markets are a bit like the weather; complex forces are at work even if conditions on a given day are relatively ideal, sunny with low humidity. Then an enormous number of small variables interact and suddenly it is hailing and everyone wonders what happened. Moreover, many of these variables have technical names that obscures their meaning.

When I was starting out as in investor in the 1990s and I was trying to figure out what was true, I had the chance to talk to George Soros. For reasons that were never quite clear to me, the chief of the bank I worked at refused an invitation to appear at special international CEO-only meetings. Through some Rube Goldberg corporate process, the invite was refused enough times that it ended up on my desk and I went in the CEO's stead, whereupon I came into contact with Soros.

Soros tried to outline his philosophy in *The Alchemy of Finance*. I say tried because the writing is passionate, heartfelt and convoluted. His key idea is that markets are riddled with self-reinforcing processes. I believe this is both profound and true. Soros used the term "reflexive." For instance, if you buy a stock, all else equal, the price rises. Seeing the price go up affirms your hypothesis and often makes both you and others like the stock more even though the stock is now, logically, more expensive and a *worse* investment when measured in terms of expected return. In this way, perception diverges from reality.

With that in mind, a stripped down framework for answering the reader's question.

1. **The economy and financial markets are logically distinct and inter-relate**. For instance, when stocks go up, people who own them feel wealthier and spend more. When they fall the opposite happens. When assets fall a lot, like in the 1929 Depression or the 2008 credit crises, the psychological scars last a long time, decades.
2. **When people say the "economy" or "GDP" they mean spending**. GDP doesn't measure many things that matter, like happiness or integrity.
3. **Spending equals income plus borrowing times how many people exist**, which is called population growth or demographics.
4. **Income** varies by sector (barber versus doctor) and is largely a function of both the rarity of the skill (brain surgeon) and output, which is called productivity.
5. **Technology** boosts productivity. If a farmer replaces a horse with a tractor, output rises. Technological change is self-reinforcing. One invention, an iPhone, allows other inventions, like Waze.
6. **Borrowing is spending tomorrow's income today.** Taking on debt boosts wealth (a spiffy house) and simultaneously creates a financial vulnerability, the need to repay a known obligation (debt) with a variable source (income).
7. **A growing population** is self-reinforcingly positive for economic growth (more babies=more spending) and a shrinking population the opposite. Countries attractive to immigrants are structurally advantaged relative to those that are not.
8. **If you earn more than you spend, you save**.
9. **Financial markets,** or capital markets**, connect savers with borrowers.** The farmer needs to borrow to buy the tractor and the person with idle capital wants to lend and make a return. Capital markets are self-reinforcingly positive for wealth, which is one reason why places that did not develop them, like the Soviet Union, collapsed. If capital markets become too volatile, they lead to chaos, like Weimar Germany.
10. **There are different ways to borrow and lend money**, each with different advantages and disadvantages to borrower and saver. For instance, a stock allows a company to raise money without being obligated to repay it but also requires them to forfeit a degree of control. An investor combines assets into a portfolio with the goal of earning a return that is more reliable in aggregate than any single asset in isolation.
11. **Every asset price is an expectation**. Apple's stock price today includes expectations about how many iPhones will be sold later. If those expectations are too high investors will lose money and vice versa.
12. **Assets price relative to each other**. If the yield (interest rate) on cash is high, investors will be more reluctant to endure the volatility of the stock market. If the yield is low, they might.
13. You can't have economic activity without money; the government prints the money. (Bitcoin and gold are exceptions, a separate story).
14. **By determining the supply of money, the government determines its yield, like the interest rate earned on holding cash in your bank account.**

15. **In general, assets go up when the government creates more money and fall when the opposite happens** and, to foreshadow next week's post, governments have been printing a lot of money and soon will begin to print less, as the chart from Rose Technology shows. **The more assets rise the greater the economic sensitivity to their fall.**

Religion in the Modern World

Do you believe in God? I asked.

I do, the man answered, but I consider these questions so private they are best not discussed in public.

He was hale, in his 60s I'd guess, and a Nobel Prize winner. I was a gangly teenager at a dinner my father, a scientist, had organized. My father wasn't drawn to religion; I wondered about the spiritual perspective of another adult who was clearly gifted in logical inquiry.

The scientist was on to something. These days, we are more likely to discuss our exercise regime than our spiritual practice. Until relatively recently, religion played a dominant role in Western political and social order, articulating a set of shared values. In the East, religious teaching drawn from Confucian, Buddhist and Daoist traditions also play an important role. In much of the West, polling suggests confidence in organized religion is weakening, even as faith in God remains very high.

My conversation with Rabbi Michael Friedman, click this link, is about his individual path, Judaism and religion more broadly, all crunched into 44 minutes. I learned a lot. On the eve of Judaism's high holiday Yom Kippur, a day of atonement and repentance, I thought you'd enjoy this conversation as well.

Dear Readers…

Today was the first time I mailed out a "subscriber-only" letter. I shared my logic for paid subscriptions a few weeks ago here. From now one, I will make certain letters subscribers only, typically those more closely tied to the investment outlook. If you want to read The Outlook and Ms. Eilish, sign up. If not, we will re-connect next week!

Wednesday we release the next podcast, a conversation with Dr. Alexander Vanyukov, a Moscow heart surgeon who has been on the Covid front-line. He describes watching his hospital get overwhelmed, putting out a call for volunteers and then the surprising experience of what happened next.

The Outlook and Ms. Eilish

Over there, said Billie Eilish, wearing a baggy white T-shirt, shorts and hi-tops, waving toward a section in the crowd. In the VIP section, you guys doing all right?

Fu@# the VIPS! Boomed the crowd packed around me.

The anger came from some place deep (I'm paraphrasing, I didn't record the precise words). This emotion may come from the fact that young people probably face slow, volatile, economic growth, a chaotic information landscape and see problems like global warming as both scary and without an obvious solution. Polling seems to confirm this sentiment. Given that, the biggest investment risk is less a shift in inflation and more a radical shift in the system—and not just in the US.

When it comes to investing, I follow a practice. Here are the steps:

a) **Have a framework (covered in Part 1 last week) to make an investment decision,**

b) Guess what future conditions will look like, including possible low probability events,

c) Know how different investments—stocks versus bonds—react to events,

d) Look at what an investment costs and how it's priced relative to other assets—ideally you find a Mercedes priced like a Hyundai.

Today, I will cover "b," the outlook, and in subsequent posts will cover the rest. Disclaimer: This is not investment advice. You can and will lose money on investments. I've lost money on plenty of investments.

The Outlook

We are in a pandemic, which will pass. What follows next will likely be a period of low growth that self-reinforcingly feeds political instability even as innovation continues to eliminate the middle-man. I come up with this by unpacking growth, inflation and the risk of a systematic break.

Growth

Growth, as I noted last week, measures spending. A pandemic creates volatile swings in spending. Spending on hotel rooms essentially drops to zero, while demand for face masks explodes. While we are in the pandemic it is tough to understand what exactly is going on with the economy because the dials on the dashboard keep swinging around so much, like a plane going through really bad weather.

Longer term, growth has three parts: income, borrowing and demographics.

a) **Income** goes up or down depending on the job you hold (brain surgeon versus butcher), overall employment and inventiveness, or productivity. Inventiveness is producing more with less, the tractor replacing a plow. Over the last decades, US productivity has grown at about 2% a year. This creates a speed limit on growth. The IT revolution is having a huge impact on inflation (more on this below) but does not appear to be as economically transformative as past inventions, like electricity.

b) **Debt** is spending tomorrow's money today. Debt levels are now high in most major economies. It means that future has already been spent. The chart below by Rose puts the dollars of debt into perspective.

c) **Demographics**. In the next decade, the global population will grow in places like Nigeria, India and Pakistan and shrink in Europe, Japan and China. As an investor, you care about the growth of places with safe asset markets. On that count, the US, Canada and Australia have a structural advantage because they have systems that both attract and integrate immigrants well, even if their birth rates are similar to Europe.

In sum, growth probably isn't going to be very fast, but will be slightly faster in places that attract immigrants and encourage industry disruption, absent a radical, unexpected shift in productivity.

Inflation

Inflation is the average price of the stuff you buy. It is currently high, like 4% or 5%, mostly because of pandemic-related supply-chain disruptions, like temporary port shutdowns. Inflation matters because your money buys less. When I was growing up, the grocery bill was around $100 plus. Now it is $200 plus. Same food, but my dollars buy less. You can find a more fulsome discussion of inflation in Deflationary Locusts.

I suspect inflation will fall as the pandemic supply chain blocks ease, population growth slows or in some cases shrinks and because much of today's innovation is about eliminating the middle-man. Consider Amazon, which existed for almost a decade (94-03) without making a profit, systematically picking off the middle-man, financed with a soaring share price. The deflation Amazon created allowed the central bank to run easy policy, further boosting Amazon's share price, what I referred to as our stock market addiction.

This process continues (Carvana to car dealerships, Upwork to accountants and graphic designers, etc). The big areas of the US that have not yet succumbed to this are education and medical. Covid may change this. If learning is partially on-line, maybe one great calculus teacher can replace thousands of mediocre ones? If so, that would reduce education costs and likely boost quality.

A System Breakdown

Low growth weakens confidence in the political system, which then fuels the angry burst evident at an otherwise upbeat and fun Eilish concert. Wealth gets destroyed when political systems fracture. Civil wars are more frequent when growth is low, the government is seen as unresponsive, rule of law is weak, antagonists are unable to negotiate and information channels are chaotic.

This seems to fit a number of countries, including the US, parts of Europe and China. For instance, in the US, inhabitants on the wealthy coasts have a political agenda at odds with those who live in rural areas, who are are over-represented in the Senate. This tension on everything from election integrity to abortion risks creating a Constitutional crisis. In authoritarian countries like China the slower the growth gets, the tighter their controls need to be, which also threatens the system.

Over time, the list of countries that have experienced such a break is long and is most evident in their currency, which typically becomes worthless when populist parties undertake irresponsible monetary and fiscal policies. Obviously, a scary thought. The chart below from Rose shows currencies in log scale against gold (as a reference point). The point: when the system breaks, wealth gets wiped out. The groceries don't cost $200, they cost $20,000, which is a risk I consider in my asset allocation. More on that, later.

Volunteerism In The Time of Covid

Alexander Vanyukov is a heart surgeon in Moscow, husband and father of two. Like all of us, Covid turned his life upside down. Only, he wasn't hiding out in a country house making as needed dashes for groceries. He was at ground zero in a hazmat suit and goggles trying to prevent some of Russia's 200,000 reported Covid deaths. Excess mortality suggests the actual figure is closer to 600,000.

As regular readers know, while I grew up in the US, I am fascinated by foreign cultures, particularly Russia. I've seen the pendulum swing from Soviet Union as enemy, to Russia as friend and back to Russia the enemy. When we are in the enemy phase, I detect a hardening of perspectives about the humanity of not just the government but the people of whomever one country or another holds as the current enemy. That's why Alexander's story leapt out. You can listen to the conversation here and also on Apple. A few lessons I took away.

1. "If you need help, just ask." Alexander saw a hospital overwhelmed and came up with the idea of putting out the call for volunteers. He thought a few people would respond. Thousands reached out.
2. Getting an outsider's perspective is invaluable. "Their lack of medical experience and typical patient interactions was incredibly useful because they weren't desensitized to the patients' needs as most of the doctors are. So they were able to see certain issues, like someone who hasn't been approached for a while, a lot more quickly than the medical staff," he said.
3. Russia is experiencing a "crisis of trust." Accomplishing difficult things that require a joint effort is so much harder where distrust is the starting point. I see the same thing in the US.

If you enjoy these podcasts, please rate them on Apple and spread the word about Things I Didn't Learn in school to your own personal network. That makes a huge

difference. You can also help by switching your membership to paid, which supports the team behind this.
Enjoy.
Paul and the Still Press team

The Art of Not Destroying Wealth

Then I went broke, said the investor, now very wealthy. He was recalling a time when he lost it all.
At least he made the money back. I know a number of people who did not, typically when circumstances shifted in ways that were hard to foresee and impossible to recover from. A sudden lurch from a crazy political leader, plague, or the economy.
Wealth is unstable. It's hard to earn and easy to lose. Many of the people, companies and countries that have money now won't in the future. If you sit on cash, inflation eats away your stash. Right now, US inflation is around 4%, the yield on cash is zero, meaning cash is guaranteed to lose 4% a year! If you take market risk, you take risk. We must live with this uncertainty, even smile at it.
The chart below created by Rose Technology illustrates this. It shows the top countries in terms of GDP per capita going back … 1000 years. The country with the highest GDP per capita in 1150 was Iraq, as of 2016 the order was Qatar, Norway, USE, Luxembourg, etc.
Today's post is the third in a series answering the subscriber question: what is the big picture and what should I do about it? I first shared my investment framework, then my outlook, today is about what to do. Post-pandemic, the most likely outcome is low growth and low inflation BUT the political risks are so high now growth and inflation almost don't matter.
In particular, the US and China, the two largest economies in the world, are both threatened by a cult of personality. This undermines the rule of law (stronger in the US to begin with) and threatens wealth. The recent article by Robert Kagan about Trump and George Soros about Xi are both important.
Asset Allocation
Asset allocation is both boring and important. An abbreviated version.

1. When you invest your savings, you are participating in what's called a capital market.
2. A market for capital is different than, say, a farmer's market. Unlike buying an apple, when you invest, there are two steps. First spend money, then get the money *back*. Call it renting out your capital.

3. There are three primary risks when you rent out your cash: you don't get repaid, you get repaid in money that isn't worth what it once was or your payment gets delayed, sometimes for years. Visualize a tenant not paying, or paying in money that is losing value very quickly or paying after a protracted legal fight. In Wall Street lingo, these risks are called default, inflation or illiquidity.
4. Rent can be structured in different ways. The structure is important to understand because it relates to how to protect yourself from wealth shifts. There are three primary structures:
   a. A loan, also called a bond. If the risk is low, the interest rate is low. If the risk is higher the interest rate is higher. Either way, a bond is a contract. If the government borrows, your risk of default is low. If a new tech start-up borrows, the risk is higher.
   b. A share of the business. This is also called a stock or an equity. It means you own a slice of the business. The owner is under *no* obligation to pay you back. If the business does well the return can be much, much higher than a bond. If it is bad, you get nothing.
   c. Switching your currency. This means you get paid your rent not in dollars (or whatever your home country is) but in gold, bitcoin or some other material that can be exchanged for currency.

The art of not destroying wealth is to hold a bit of everything. My starting point is 1/3 bonds, 1/3 stocks and 1/3 some form of "switch your currency." Government bonds are good when things are bad, like 2008. Stocks are good when things are good, like this year. Switching the currency provides protection when your home country goes bad, either due to inflation or a demagogue.

So for instance, if I bought a house in Canada and rented it out, this would be like a bond (the rent) but also switching my currency, I'm paid in Canadian dollars. Or buying the stock of a foreign company that produces commodities. This is a share of a business but also switching my currency (the commodity they produce).

At the same time, and this is why investing is tricky, I don't follow this rubric rigidly. Also, THIS IS NOT INVESTMENT ADVICE, YOU CAN AND WILL LOSE MONEY, I HAVE MANY TIMES. I deviate from the above, particularly around what I'd refer to as the gas and the brake.

The Gas and Brake

Only the government can create money. Printing money is stepping on the gas. Reducing money is stepping on the brake. If the government, reduces the supply of money, assets fall. Most of what you earn on an asset allocation comes from when the government is stepping on the gas. So be mindful when they step on the brake. Right now, the US is planning to step on the gas a bit less hard. That's one reason why the stock market stopped going up.

Next week, for subscribers. I'll share my current asset allocation in more detail. **If you are enjoying these, become a paid subscriber.**

My Bets

"I never had a long-term plan. I plan six months ahead. A series of six months plans is a long-term plan."

It was the early 2000s. I was trying to leave the lumbering commercial bank where I worked. An entrepreneur friend was describing his thinking to me. The same applies to managing money. I try to see through the fog, probabilistically, six months out.

This post is the fourth and final in a series answering a subscriber's question: what is the bottom line, what are your bets? First I provided a framework for such decisions, then an investment outlook, then a tutorial about how different assets work. Today's piece is the most technical. Hopefully, all four of the pieces fit together as one.

The "lull" I've referred to throughout is a period of time where risky assets like stocks and commodities do well before we face a shift that may be terrible for assets. A rapid Fed tightening and what I've called the cult of personality in both the US and China are real risks.

A caveat: THE BELOW IS NOT INVESTMENT ADVICE. INVESTMENT IS RISKY, YOU CAN AND WILL LOSE MONEY. I find people talk about money the way they talk about sex, in private, and suspect we'd probably do better to talk more openly about our investments, compare notes and learn.

Below is my current portfolio. The numbers are as a percent of capital. If I had $100 in my portfolio, $42 is long stocks.

Here is my thinking:

1. My goal is to earn a 5% to 10% return each year with roughly 10% risk. Managing a portfolio is a trade-off between risk and return. There is a mathematical relationship between these two numbers, confidence in each investment and the ability of certain investments to reduce risk. (This math is what investment pros describe as an "information ratio," the expected return divided by the expected risk.) Suffice to say, you need to know your own goals and risk tolerance and think about what can hurt you.

2. My starting point is 1/3 stocks, 1/3 bonds and 1/3 switch your currency. I then deviate depending on conditions. Switch your currency means a combination of commodities like gold and copper plus actual foreign currencies that protects against both inflation and a sharp decline in one's home currency.
3. Stocks. I own more stocks than my typical. I think we are in a gradual, post-Covid recovery that will be good for earnings and the alternatives, bonds, are generally unattractive. Half my stocks are foreign as I worry about how expensive many US stocks are.
   In the US, I am concentrated in banks, tech and oil. Each sector has its own dynamic. A bank borrows short term and lends long term. To over simplify, as the difference between these interest rates (short and long) rise, a bank makes more money. That's what is happening now. Oil is unrelated (diversifying) to other stocks (more below) given the substance they produce as a *profit* is an *expense* for most other businesses. My US tech exposure is about 5% of my total portfolio. Given a roughly 20% exposure to US stocks, if they fall 20%, I lose 4%. I can handle that even if I won't like it. The above stock allocation is *very* different than the typical asset allocation a financial advisor recommends. That is a separate discussion.
4. **Bonds.** I hold less bonds than normal and no US government bonds. The real interest rate on bonds is solidly negative. Effectively, I have to pay the US government for them to borrow my money. I own foreign government bonds, some of which are in emerging markets, and securities with higher yields from US government insured borrowers. I partially hedged the risk the Fed raises rates by going short the interest rates they might increase. In other words, short-term US bonds are unattractive to own but attractive to hedge. The chart below shows the type of scenario I worry about. It shows this current portfolio (minus the hedge) drawn back through time during a recent Fed rate hike. It loses a lot of money.
5. I have more than 1/3 of my money in "switch your currency." This is reflected in outright exposure to foreign currencies (36%) but also in my exposures to real estate and commodities. Recognize if you buy a foreign stock, you own the stock *and* the currency. There are two things driving my switch-your-currency-bets. First, global warming will drive increased demand for raw materials to mute the impact, like flood control and air conditioning, which are commodity intensive. So too is green energy. Many of these stocks also provide high dividends, which provides some income. Second, given stimulative policy in the US and generally less stimulative policy abroad, the relative attractiveness of foreign currencies and hard assets is higher than average.

6. I have exposure to both an equally balanced asset allocation, a number of hedge funds and credit managers. This is me outsourcing some of the money management to others.
7. My overall exposure is above 100%, meaning I use modest amounts of leverage in my portfolio. That is also a separate discussion.
8. As the facts change, my asset allocation changes. Most of this is liquid, meaning I can sell it in a day. Fingers crossed.

Ray Dalio, Unplugged

It's hard enough to know ourselves, let alone others. We are contradictions, moods and degrees of disclosure and so are those we try to understand. Observer and observed are in motion. Those familiar to us also remain elusive.

I first met Ray in the summer of 2004. Bridgewater Associates, the company he founded, had around 150 people. I asked around Wall Street and people said Ray was unusual and wrote great research. (I now think he writes great research because he is unusual). Bridgewater wasn't famous, even though Ray had been assiduously building it since … 1975. There were no written principles.

I worked for Ray for sixteen years, retiring last year. In that time, I watched Ray go from hard working and obscure to hard working and famous. Bridgewater became the biggest hedge fund in the world and Ray became a billionaire. The last time I was in China with him, people stopped us to take his photograph.

While I often experienced Ray's sometimes impossibly high standards first hand, there was still a lot I didn't know about him. In our conversation I purposely skipped his economic outlook, views on China and principles. Much of that is available on-line. Instead, I wanted to ask him some of the questions he asked me in my 2004 job interview. What growing up was like? How did he find his path? If he was comfortable, I also wanted to discuss every parent's worst nightmare, losing a child. I appreciated his candor and think you will as well.

You can listen for yourself with this link. The podcast is also on Apple podcasts and my website.

I took away a few lessons.

1. Early in life, independent thinkers might seem merely quirky rather than possessing unique insight.

2. Ray didn't start out trying to create a great company; he had curiosities and wanted to follow them in a way that generated enough money to live. Bridgewater grew out of that.
3. Great analysts sometimes get forecasts egregiously wrong.
4. We all experience loss. While always painful, when it happens out of the normal sequence, like the child dying before the parent, it is excruciating.

Likely you will have different take aways. I'm all ears.

A Diabolical Challenge

Money is both a constant in human life and constantly unstable, like the ocean. Sometimes money lurches from one market to another, like a stock market crash. Sometimes prices begin to rise, like now. Eggs cost 12% more than a year ago. An egg is an egg, you just pay more for it. If your wealth is fixed and eggs cost more, effectively you are now poorer.

Inflation is tricky for investors. Some of the assets most commonly owned, like stocks, generally don't do well when inflation becomes a problem (though they have done well this year). Once people become alert to inflation, the assets that can help protect are already expensive. And, if in response, the central bank sharply reduces the amount of money it is printing *all assets fall*.

To deal with this, professional investors resort to other techniques, like futures and shorting that are not a good idea for the untrained. Shorting in brief: Say a box of eggs costs $10. I can short it by saying, "I'll pay you $10 for your eggs…in a month." I borrow your eggs and sell them for $10 that day. When the price of eggs falls to, say, $5 in a month, I buy the eggs and give you yours back. I sold for $10 and bought for $5, making $5. Like I said, shorting is complicated.

The Problem

Economists can not reliably predict when inflation is going to shift higher or lower because inflation has too many moving parts. Inflation is the average price of a pile of stuff, from semi-conductors to cement. While keeping track of all the moving parts is impossible, as a hack I reduce inflation to just three pieces: labor, raw materials and housing.

For everything you buy, someone needs to make it (labor) and transport it (raw materials), and all involved need a roof over their head. That's inflation. The below chart shows actual CPI, as reported by the government, and then an estimate (thanks Rose!) that is 66% labor, 17% commodities and 17% housing. It tracks pretty well and you can see the prices jump recently.

In the US over the next 10 years, inflation is expected to be about 2.5%. This isn't an opinion. This number is extracted from the bond market by looking at the difference between what's called a nominal bond and an inflation-linked bond. This measure of expectations is objective, like your weight on a scale.

Inflation right now is around 5%. This means the market believes inflation will fall from here (from 5% to 2.5%). I suspect that is right. Think labor, commodities and shelter. Tens of millions of people are seeing their jobs disrupted, which has created supply/demand imbalances as has an exodus from cities to suburbs. That said, I could be wrong, so I need to have a plan.

Least-Worst Solutions

There are three assets that might help an investor navigate inflation: real estate, commodities and inflation-linked bonds. Real estate and commodities are almost intuitive. If you think food prices were going to spike further, it makes some sense to fill your home or apartment with food today and eat it tomorrow. Wherever inflation settles the real estate and commodities will sell at that price.

Inflation-linked bonds are less familiar, technical and a topic a reader asked about. An IL-bonds pay you real (inflation-adjusted) interest. That means if inflation rises further from here, you get more money, which would help. It also means an inflation linked bond has two moving parts, a real yield and inflation compensation. A regular ten-year nominal bond yields 1.7% thus can be divided into a roughly 2.5% expected inflation rate and a *negative* real yield. Why would you buy a bond with a negative real yield? Because yields on cash are even *lower*. **Cash is zero and inflation is 5%, meaning real cash yields are -5%.** If there is a fundamental force in markets, like nuclear energy, it is these real yields. When cash is a terrible investment it forces money out into the economy and markets. **These yields impact every asset you can buy.**

IL-bond real yields can rise (hurting an investor) in one of two ways—either inflation falls (and real yields thus rise) or the Fed raises rates. The long-term chart below shows the relationship of interest rates to a popular nominal bond ETF. When the Fed raises rates, it is not pretty. An inflation linked bond will look even worse.

From here, inflation likely falls or I am wrong and it rises and the Fed acts. *If inflation rises further and the Fed does nothing, inflation linked bonds are a good deal.* That could happen, but investing is about making good risk reward decisions. Given how low short-term interest rates are right now, the cost of selling short-term bonds is low. These are the interest rates the Fed would raise. **While this is NOT investment advice and you can and will lose money investing**, for transparency my inflation hedge is a roughly 30% short on short-term interest rates, 10% long commodities and 8% long real estate. I don't hold any inflation linked bonds.

Boom, Bust and Redemption

A few weeks ago, I wrote about The Art of Not Destroying Wealth. Wealth is unstable, hard to accrue and easy to lose. The latest podcast is a case study in both the art of gaining it, a case study in how to lose it and, perhaps more importantly, a discussion of how to keep perspective as the world's perception of you gyrates.

My guest Dan Zwirn is a sophisticated investor who provides finance of the type I read about in books from writers like Honore de Balzac and Victor Hugo. There have always been complicated flows of borrowing and lending, transactions a bureaucratic bank can't get in the middle of but if you can figure out the details and collateral and have an appetite for risk, you can make a bundle.

Dan had the idea for this type of company … in his 20s. By his 30s, the company was a reality. He was managing billions and was worth hundreds of millions of dollars. It's an understatement to say that type of vision, drive and execution at that age is rare.

Then, disaster.

I've always been wary of the authorities. The authorities to me mean the IRS, state police, local police, anyone who legally has the right to abridge my liberty. When I've been in authoritarian countries, I've been cautious about the secret police as well. These structures exist in different forms and to different degrees in every country. They have enormous power.

For a US hedge fund, the dominant regulatory authority is the SEC, the Securities and Exchange Commission. Dan identified and self-reported an issue at his fund to the SEC, thinking self-reporting was the right thing to do.

The SEC agreed with him. However, agreement came in writing many years later. Between reporting to the SEC[1] and getting a letter from them saying he hadn't done

anything wrong (but a CFO had), Dan lost his wealth. Now he is re-building his original vision. This is his story.
What's it like to go boom to bust and bounce back? Probably different for everyone. Dan found comfort in the Stoics (note to self, read more classics). Think Seneca or Marcus Aurelius.

By the way, on the topic of wealth shifts, Sunday's paid post was about navigating inflation, including about the potential risks of a less known instrument called an inflation-linked bond. For whatever reason, the market action in the ensuing days is the very type of thing I was worried about. Let's see if it lasts.
If you enjoy Things I Didn't Learn in School consider becoming a paid member, that's what supports the team that makes this happen.

Does Profit Snuff Out Inovation

The magic of 007 broke when "M" downed whiskey after whiskey in his office. We know fiction is an invention, yet still feel disappointment when that becomes obvious. Today smoking in the office is verboten and the head of British Intelligence is knocking back Macallan at work?
The narrative logic for a film series is brand consistency, not innovation. Bond is a formula; profit creates an impediment to innovation. The same is true for the established company. A tried and true structure and solid results give the appearance of permanence but also sow the seeds of collapse. Knowing this is critical for both investing and career management.

I wrote before about how All Companies Die. The median time a company is in the Dow Jones Industrial Average is 10 years. The latest 007 film is a reminder of why. Like the Bond films, the profitable corporation is often the vision of an eccentric, self-promoting creative. Once a formula is discovered, however, significant creativity ends and tinkering begins.
Consider the parallels between Apple founder Steve Jobs and 007 creator Ian Fleming, both of whom died young and left cash flow empires. Each re-imagined an existing idea. Ian Fleming made Eric Ambler's understated hero suave and wry, added gadgets, beautiful women, cartoonish bad guys and locations more aspirational than Eastern Europe. Jobs looked at Epson laptops and Motorola cell phones and realized they could be much better designed. "He liked the notion of simple and clean modernism produced for the masses," biographer Walter Isaacson wrote.

Both died at age 56 having invented a score others now play, over and over. In Job's case the direct descendent is Tim Cook. In Flemming's, it is Michael Wilson and

Barbara Brocolli who own Eon Productions and retain creative control over the 007 films.
The chart below from Rose (thanks Rose!) shows the return on the 007 franchise, which is profitable and seeing gradually diminishing returns per dollar invested. The empire is fading but not to such a degree as to provoke real innovation.

Playing the music requires a) scale and b) great musicians. Followers are different than founders. **It takes arrogance and impulsivity to create an empire and humility and consistency to work in one.** Jobs' reality distortion field is familiar to anyone working as an entrepreneur; you need to summon confidence in something that doesn't yet exist. In the orchestra, scope for creativity exists but is far more constrained. This is not to denigrate the orchestra. All work is noble and it takes unbelievable discipline to learn to do something well, like play the violin.
About 147,000 people work at Apple. You can analyze Apple's numbers in different ways. One of them is how many business lines were created after Steve Jobs. Most Apple sales come from the Mac (released in 1984), iPhone (released in 2007), and iPad (2010), or services tied to these products, like Apple Care. By this measure, post-Jobs innovation is close to zero, as the chart shows.

Yet, profits were almost $60 billion in 2020, more than twice what they were when Jobs died. Apple is not an isolated example. Microsoft replaced the typewriter and graph paper with word and excel. This cash flow supports 163,000 employees. The meaningful evolution post-Bill Gates is cloud computing, perhaps forced because Google, Apple and others began to encroach on Office.

While stock valuations are elevated now, going forward something will shift (though exactly when I don't know), profits will fall and, in the case of companies that die collapse. Could a hardening of trade barriers between China and the US and a government led push for self-reliance eviscerate a large swath of these companies' profits? The very people that make existing operations run smoothly are the same type of people unlikely to undertake radical adjustments.
For those early in their career, this means you need to match your gifts with the right type of company. If you work in a company as established as 007, the music has already been written. The company needs excellent violin players, not composers.

Creativity is, if anything, a *problem*. If, however, you are a tight operator and excellent violin player, these corporations can be a great place to work, until conditions shift.
As an investor, I try to be open minded to disruption. The rewards for knocking down a giant are massive. This is the reason why Elon Musk has achieved cult status. The market is saying in 15 to 20 years we won't have gas driven cars and he more than anyone else has made this happen, a true composer, though I suspect he has largely hired violin players.
Let me know your thoughts, paul@paulpodolsky.com. Reader feedback helps shape subsequent posts. And please consider becoming a paid subscriber, which helps support my team.

The Nest, the Soul and the Calculator

Numbers imperfectly capture reality. For instance, we measure each minute the same and experience some as fleeting and others as interminable. The same is true when it comes to real estate; buying property probably doesn't make sense strictly in terms of numbers but might make sense from the perspective of emotional safety, family memories and community.
A younger reader asked about how to think about a real estate purchase, thus today's post. I made my first real estate investment because owning a home made my wife, who grew up in the cramped Soviet Union apartment, happy. In other words, pure emotion. All money decisions are emotional, but housing is different because:
1. Unlike buying a stock or a bond, you will live inside this asset. The word house is different from "home." The oldest tales, like The Odyssey, are about finding your way home. For many, buying a property is also, frankly, about reproduction. Salmon meet in the cities and spawn in the suburbs.
2. Buying property generally costs more money than a buyer has, which both means they need to borrow and the relative impact of this decision is much larger than other financial decisions.

In a follow up of this post, I will share some calculations I use to judge if real estate is cheap or expensive. Before getting to those, however, it's important to disaggregate the moving pieces in real estate.
The Moving Pieces

1. The price of a house or an apartment, like anything else, is determined by supply and demand, both of which fluctuate. A property can be further sub-divided into the physical structure and the land itself.
2. In the aggregate, real estate tends to rise in value over time, mostly due to inflation.
3. In the specific, however, real estate prices are very much contingent on local conditions in which there is enormous variation. You've probably experienced moments where something statistically unlikely occurred to you. For instance, as a teenager, I almost froze to death on a camping trip in the second worst storm West Virginia recorded. Freak storms happen in real estate, too (like a pandemic).
4. In addition to real estate price fluctuations, an investor is exposed to the following, all of which are unstable:
   - Income. That is what you will use to pay off the debt. Income is unstable, while the debt is not.
   - Debt relative to your other assets.
   - Borrowing costs, which fluctuate.
   - Liquidity. It is possible to be "rich" with real estate but "poor" in terms of cash.
5. If you buy with debt, you are locked into a series of transactions. If your job is fine and real estate prices gradually climb, all is well. If these variables start to work against you, pain can spiral. Imagine a stock market crash (your assets fall), that leads to your layoff (your income falls) and hurts appetite for real estate, your house price falls. Boom, you are in a snow-storm.

History and the Future

The typical advice to novice stock market investors is to buy an index, like the S&P 500, because betting on an individual stock (which also has a lot of moving pieces) is way too hard. With real estate, that's not possible for the typical investor. You have just one house or apartment.Anticipating shifts in housing supply and demand is tough. The classic example of this is Japan. They experienced a massive real estate bubble in the 1990s and thirty years later … houses are still under water as the chart from Rose shows (thank you, Rose!).

A less well known but even more compelling example is the US. As Yale University's Robert Shiller points out, from 1890 to 1990 the real (inflation adjusted) prices of US houses … fell. Cars allowed people to move to the suburbs and home construction became more efficient. In other words, supply increased so prices fell.

Note that since then, however, US housing prices have shot up in real terms. There are two reasons. As real interest rates have declined *everything* has gone up. And in the pandemic, many scrambled for housing.
Yet this might not last, both because the central bank (the Fed) will reduce the amount of money circulating and, as the virus ebbs, remote work has freed us from tying our residence to our work. Why endure bad weather if you can hopscotch elsewhere? If you have kids in schools, this is impossible. But for everyone else? There is now a vast real estate arbitrage of moving to places with decent weather but bad employment and cheaper real estate. No one knows exactly where this will net out. It's also worth noting that politics can radically shift prices. There was a booming commerical real estate market in … Latvia. Then came the Nazis, followed by the Soviets. Not good for real estate.
What Isn't Captured in Numbers
To be sure, housing has its advantages. Having a mortgage forces you to save. Owning property anchors us to a community. I am reminded of Eudora Welty's story Death of a Traveling Salesman. On his death bed, he realizes he never put down roots. Many families have priceless memories tied to their modest summer cabin on a lake. Real estate can also help you hedge against inflation (as long as local supply does not increase) and in certain countries, like the US, there are tax advantages to owning.
Yet, financial analysis shows most Americans who own a house now would have been better off renting and putting money in the stock market, as the chart below shows, in part due of course to the fact that stocks have gone up so much.

Jim Comey – Watching the Train Leave the Station

On my best days, I look at others with curiosity. I like to try to imagine their motivations, even if that person does things differently than I would. At the end of day, we each render a judgement, but I try to go there only after imagining what the other person's shoes feel like. Nothing new in that wisdom, but a struggle to consistently apply.

When I told acquaintances Jim was kind enough to appear on the podcast, I got a range of reactions. (You can listen to our conversation on Spotify here (or find it on Apple Podcasts). A number of people said, “oh, he is controversial.” That’s true. Some liberals think he gave us Trump and some on the right-wing fringe think he is part of a deep state. His story is interesting enough that Showtime made a series about it, which is now on Netflix.

Jim and I briefly crossed paths at my previous employer. We worked in different departments but management meetings were taped and shared, which is where I first saw and heard him. I listened for about a minute and said to myself “this guy is cut from a different cloth” and reached out. As I recall, our first exchange was about a book on Constitutional Law!

I then watched, like many of you, what happened next. He was appointed head of the FBI, which seemed in many ways a dream job for him, a better fit than corporate. His awareness of the battle between good and evil, truth and falsehood, was both inculcated at a young age, reinforced as a teenager when he and his brother were held at gun point and further honed when he worked as US Attorney against mob bosses, something he discusses in his most recent book *Saving Justice*.

In our conversation, I purposely did not ask about the things that he has already discussed, like what he thinks of Trump. Instead, I wanted to get a sense of his background, the balance we all face between ego and humility, what lessons he has drawn from his experience and other topics. I took away a few lessons.

1. **It all begins when we are young**. In Jim’s case, he grew up with a very strong moral compass.
2. **The truth is both difficult to ascertain but also the fundamental force from which other sources of power flow—scientific inquiry, productivity, functional government.**
3. **Assume most people either aren’t forthright or aren’t aware of their own flaws.**

I’ll be interested to hear what lessons you draw. Enjoy.

-Paul and the rest of the Still Press team.

Follow the Money

People who make good decisions rely on good frameworks. The doctor doesn’t diagnose randomly, symptoms are matched to a rubric. The framework behind these posts is this—follow the money. In a later post, I'll share the frameworks behind the podcasts.

We are all incarcerated in a money cage. Money exerts power on our lives whether we acknowledge it or not. Openly talking about money can make us feel vulnerable. At the same time, money talk can sometimes be terribly boring. It's a paradox.

Yet, learning how to follow the money, to see how the cage is engineered, is powerful. It also deepens other perspectives, like psychology and history. I want to teach you how to read the newspaper backward. What do I mean?

Money is relegated to a separate section, Business. But the best way to understand the Front Page is to start with understanding the Business Page. **The economy generally drives politics, not the other way around.** The roots of Trumpism are flat wages. Inflation (more on this below) may do in Biden.

I stumbled on this approach. After college, I wanted to become a writer and figured living abroad might help. In my roach infested apartment overlooking Moscow's ring road, I quickly found my education didn't equip me to understand what I was seeing, like coups, hyper-inflation, corruption and an explosion of entrepreneurialism.

What was going on? In the Soviet Union, very basic things didn't work, like toilet paper. In the US, commercially viable toilet paper became available in 1857. The Soviet Union, a country with some of the biggest forests in the world, could not reliably produce and distribute it.

The explanation for the toilet paper deficit was not to be had in Tolstoy, Russian language or international relations, though these are all interesting. The easiest explanation was that the Kremlin had the wrong price on toilet paper. It was that simple. The price did not incentivize the right action. With that realization, I decided to force myself to learn how money worked, even if I was bad at math and couldn't (yet) see how money related to being a writer.

As I learned more about money, however, I noticed certain benefits. When I had a bad consumer experience, for instance, I knew exactly who to go to exert pressure (hint: not customer service). Learning to invest was even more transformative. I could express the picture of the world not only in an essay, but it in a series of investments. If the investments made money, I had the right picture and if they lost, I learned. The feedback for bad decisions was swift and merciless, which accelerated learning.

I am still in the money cage, just like all of you, striving to improve my understanding of the architecture and hoping, through these posts, to share that understanding. The posts come from a mental architectural drawing of how money flows through our bank accounts and the economy. The below is the foundation, with links to relevant posts embedded. Over time, I will further develop this on my website paulpodolsky.com.

1. Money begins with printing. No one has ever figured out exactly how much money to create.
2. Printed money shows up in the economy and in financial markets. The economy is spending. Too much money in the economy is inflation.
3. If you earn money, you are often dependent on a corporation, which is unstable.
4. If you have excess money, you save. This money can go into stocks and bonds, or real estate.
5. If you save enough, you can stop working.
6. Global wealth shifts are ancient and lead to conflict, which is very expensive.
7. The US is trying to preserve its global position but doing so from a weaker financial position.

More Recently:

Last week, the US government issued a report showing prices are rising quickly relative to history. If you look at the wages of people who get paid by the hour, they are beginning to *contract* if you measure them *after* inflation. **This is a big deal.** This means the truck driver or roofer is seeing the dollars in their paycheck *increase* and what they can buy in the store *decrease*, as the chart below from Rose shows. If you wonder what would crush Democrats in mid-term elections, this might be it.

Money Bad

Vladimir Putin wants respect. He might feel he needs to invade Ukraine get it, which is why you are seeing stories about Russian troops massing on Ukraine's border. Unpredictability may be useful in geopolitics, but it is terrible for investment. The poor long-term return on Russian stocks is a case study in a) how disappointing emerging market or "EM" investing has been[1] and b) why rule of law and wealth are related.

My Early Lesson

The term "emerging markets," or EM, was coined in 1981 by Antoine van Agtmael at the World Bank. China had recently emerged from Maoism. The hope was that foreign investors could earn attractive returns by directing their savings to EM entrepreneurs hungry for capital. The Berlin Wall fell eight years later.

The reality was something else, as I saw first hand. In 1997, I was invited to a series of meetings with Mikhail Khodorkovsky, then worth $15 billion and Russia's richest man. Like most billionaires, he held a high opinion of himself. Putin became President in 2000 and Khodorkovsky dared to criticize the Kremlin. He was arrested in 2003, charged with fraud and served 10 years. I saw grim pictures of him behind bars and could barely believe it was the same guy. **Wealth is always unstable, particularly in EM**.

There is a Russian saying that "the severity of our laws is compensated by the rarity of their enforcement." In many EM countries, the rules are fluid and often unwritten, which means *everyone can be prosecuted* if the government choses to do so. Jack Ma, once China's richest man, was dethroned after criticizing the government, just like Khodorkovsky (though Ma did not go to prison). It is hard enough to make money investing with relatively predictable politics.

The Case at Hand

Today, if you lend a dollar to the US government for ten-years you earn 1.6%. Russia gives you 8.3%. This pricing is matched asset by asset. A share of JP Morgan is more expensive and pays a much lower dividend than the Russian equivalent, Sberbank. Why?

The geeky answer is the market is pricing in a substantial decline in the Russian ruble.[2] (This is an issue finance experts talk about a lot, but I have relegated it to a footnote because I think most readers don't want that level of detail). The conceptual answer is the market is pricing a system that is medieval. By medieval I mean a system ruled by a King, where palace rivals are poisoned, and borders are determined by relative military advantage. It's like Shakespeare, but with the internet and nuclear weapons.

There are lots of places with disputed borders like the one between Russia and Ukraine. If one country begins to forcibly shift a border, others will want the same, opening up potential chaos. In July, Putin published an essay called "On the Historical Unity of Russians and Ukrainians." Much of the essay is abstruse ("…it ended with the Truce of Andrusovo in 1667"). Putin claims Ukraine and Russia are "essentially the same historical and spiritual place." If that's what he thinks, then the border, which the Ukrainians are defending to the death, might not matter much to Putin.

Putin might not to invade. If he doesn't invade, Russian assets probably go up. Invading is expensive, will be unpopular if Russian soldiers start dying and jeopardizes a natural gas pipeline deal Russia is trying to close with Germany. At the same time, Putin believes the US is weak, particularly after Afghanistan. **The answer is unknowable**, which is why investors are stepping away. This same type of dynamic has unfolded again and again, both in Russia and other EMs.

Investors often get wiped out via the currency. If you own Russian stocks and the Russian ruble falls, your own wealth, measured in dollars, falls. The Russian ruble has yet to recover from the invasion of Crimea … seven years ago. (Though the actual return of investors looks a bit better again due to the geeky math in the footnote). The chart below showing Russian GDP measured in US dollar's, with a comparison to a neighbor, Poland. Said differently, Russian GDP would be $2.4 trillion higher if they had not invaded.3

A 30 Year Underperformance … or a US Bubble?

By all classic measures, the ruble is undervalued. Many other EM currencies also look "cheap." Yet, if Russia invades Ukraine, the ruble will become even more undervalued as foreign investors back away and domestic investors panic. While Russian stocks have earned solid returns over the last few years, they are extremely volatile, which means investors can not hold many of them in their portfolio without their performance becoming disproportionate.

The chart below from Rose is both a wall of numbers and *critical* for any finance geek. It shows the return and risk of emerging market assets. Divide one (return) by the other (risk) and you get the ratio which is like the miles per gallon for an investment. What is shows is that the miles per gallon for Russian assets are low, largely because the volatility is so high. In part, this is because Russia's oil-dependent economy is very volatile but it is also likely because of political risk.

To be sure, not all emerging markets countries are not the same. Brazil and India are what The Economist Intelligence Unit labels flawed democracies, like the US. China and Russia are authoritarian. Russia and Brazil export commodities, China and India import them. It's also worth noting that US is becoming more unstable, which The Economist ratings show. The fact that emerging markets are disappointing and the US is both expensive and increasingly unstable perhaps explains the why some (not me) are enthralled with bitcoin and Ethereum.

I'll share my asset allocation with subscribers next month. I hold less EM now than I did at the beginning of the year and have tilted more into places I'd once avoided, like Europe and Japan. My experience in Russia, including the most recent one, helps explain why. I'm also now more interested in countries on the periphery like Canada, Australia, Norway and Sweden. As I've said many times, wealth is unstable and you need to be attentive to both earn it and hold on to it.

If anything I wrote is unclear, write me at paul@paulpodolsky.com. For more access, become a subscriber or a sponsor. On Wednesday, we (the Still Press team) release *our next podcast, a conversation with Tamara Chubinidze, the founder and owner of the Georgian resteraunt Chama Mama. We've had guests on from Russia, China and France and I'd like to continue to pull in stories from around the world. Her's is a fascinating one.*

1
The shorter-term (5 year) return on Russian assets has been pretty good.

2
The ruble is discounted to decline about 75% over the next 10 years. The forward price of the ruble is a function of the local interest rate, 7.5%, relative to the US interest rate, roughly 0, meaning the ruble is discounted to fall 7.5% over the next 12 months. The interest rate pricing (which drives this forward discounted rate) is about the same at 10 years. This means if the ruble only falls 10% over the next 10 years, an investor would make 60%. While Russian assets have underperformed over the long-term they have *outperformed* on a shorter-term (5 year) basis, in part due to a compression of risk premiums after the invasion.

3
This is a bit of an oversimplification, a more thorough discussion is here. The ruble decline coincided with a collapse in oil (Russia's main export) and teasing out what exactly drove what is complex.

Inside a Georgian Kitchen (Take #2)

Separately, one reader questioned numbers in Sunday's post Money Bad. The reader's perspective was the return of Russian stocks since 2015 have been "humongous," as the reader wrote. **I cherish this type of feedback because it pushes both me and my partners at Rose to dig deeper.** We went back and looked at the data again and below is a more granular picture of the relative return of US and emerging market stocks. These calculations are useful and not precise[1]. What looks like a wall of numbers matters a lot to finance nerds and investors.

What you can see based on Rose's work is, yes, Russian stocks have done well recently BUT they are quite volatile, so volatile the return an investor gets for the risk they take is low compared not only to the US but many emerging markets. This return per unit risk (what's labeled as a Sharp ratio) is a measure of an investment's efficiency that is sort of like miles per gallon for a car. This doesn't mean you can't hold Russian or other EM stocks. It does mean though that you can't prudently hold many of them and factually, over the long-term, the returns of a broad index have been poor.

Part of this volatility is due to the nature of Russia's economy, which is highly dependent on a volatile source of income, oil. But part of it is likely because political risk rattles both domestic and foreign investors. This will not be picked up by looking at flows because you can't measure an event that did not occur. Certainly the possibility of invading Ukraine doesn't help.

Volatility exacts a significant toll on growing wealth. The classic example is having a $100 portfolio and losing 50%. Once your capital has shrunk you need a 100% return on the remaining $50 (ignoring compounding) to get back to where you started.

Other notes:

1. I will not be publishing Sunday, nor around the holidays in late December.
2. **Lastly, I am raising prices to be closer to market and also to help drive investments in data and staff to make these even better. I had hoped to provide a warning on the price change but these calculations (above) took so long I ran out the clock. If there are students or others among you for whom the new price is an issue, reach out to me.**

For those of you in the US, happy Thanksgiving. To the rest of you, we love our global audience. To all, we so much appreciate your support and interest in our venture.

Will the US System Snap?

The US system is under stress from both within and without. Because the US is the center of the global financial system, with the biggest economy and the deepest financial markets, this matters to anyone saving money. Will the US system endure the stress or, like Germany in the 1930s, snap?

For investors, this question is playing out alongside:

1. **A technology driven boom** that is improving living standards (like mRNA vaccines) and simultaneously rapidly disrupting cash flows, businesses and perhaps your job.
2. **A pandemic** that has killed 7 to 10 million people (based on excess mortality)[1], disrupted production, boosted inflation and created a psychological shock such that we are now primed for bad news**.**
3. **Waning government stimulation**. The US central bank is beginning to very modestly slow the rate at which they are printing money, what is called "tapering." This reduces the amount of money going into the economy and financial markets.

The question is how to invest to position for the good (growth, innovation and disruption) while recognizing the bad outcomes can be really bad. How much the central bank tightens is important but not fundamental. That large numbers[2] of Americans believe the last Presidential election was fraudulent is fundamental. Could a disputed US election lead to widespread violence? Will perceived US weakness lead to war in Ukraine or Taiwan?

At the root, the stress is around the relative resilience of an open (more democratic) versus a closed (ruled by "enlightened" elites) system. Because I am rooting for the open system, it's hard to be objective. Our own ability to self-deceive is high. Also, a system is dynamic, in the same way a financial market is.

Feedback Loops

We can't be objective about a financial market because we participate in them. Markets are people, us. Nations are the same. There are feedback mechanisms in each. BLM protests send a signal that generates a response. Likely fear of Trumpism helped pass the infrastructure spend bill. The *speed* of this feedback loop is critical. The gap between slavery being abolished and the 1964 Civil Rights Act was … a century.

Covid is a case study in a closed versus open system. Initially, China's lock-down response was much more effective than the de-centralized Western response. The feedback response was better. After an appalling number of deaths, an open system with private sector companies richly compensated to produce peer-reviewed studies developed amazing vaccines with closer to 95% efficacy. By contrast, Chinese vaccine efficacy is closer to 60%[3] (which, to be clear, is much better than no vaccine). Short-term, the Chinese response saved thousands of lives and I'd prefer the Moderna vaccine.

Goals and Measurement

One of the beautiful things about investing is that results provide an objective measure of the quality of an idea. The best investors get around 40% of their decisions wrong so there is plenty of grist for reflection. Your goals determine what you measure.

In investing, the goal is to get the highest return possible for the least amount of risk. In terms of government, the goal is life, liberty and the pursuit of happiness. The US, Russian and Chinese Constitutions have much in common. "Citizens of the People's Republic of China shall enjoy freedom of speech, the press…." Russia's Constitution echoes this.[4] Trump supporters storming the Capital saw themselves as patriots. The question is less what the goals are than in how to achieve them. With the help of Rose Technology, I tried to measure how we are doing.

Life

Open systems are good for life expectancy. Revolutions, be they Maoism or the collapse of the Soviet Union, are bad. Note how low life expectancy was in China in 1960.

The US has higher rates of violence than China, as seen below. Poor people in the US experience a disproportionate amount of this violence.[5] Russia stands out as having both poor civil liberties and high rates of violence. Both Latin America and Africa have appalling violence.

Liberty

Disputed elections, gerrymandering and corruption all contribute to falling US scores. In China and Russia, term limits on the Supreme Leader have been abandoned, a problem the US was trying to solve in the 18th century.

Another perspective on liberty is migration. I showed this before. People want a better life and they will go great distances to get it. In this sense, the ability to generate wealth is critical for political stability and being open seems to help with that.

Pursuit of Happiness

Over time, the US has been a wealth creation miracle. Since the collapse of the Soviet Union, China has been a miracle. Russia initially did very well under Putin (in part due to an oil boom), but wealth has since stagnated.

Given this, why has a segment of Americans lost faith in the system? Likely disruptive economic change is a factor. It’s better to be a disruptor than disrupted. The disruptors are tech and the people that invest in and support tech. To be in the top 1%, you need assets of more than $10 million.

Debates about how open or closed a society should be are ancient. Breakdowns in opens societies are terrible for wealth. So far, the US is bruised but intact but that we are having this discussion should give you pause. Later this month, I’ll share my asset allocation with subscribers.

Wins and Losses

Looking back, the best way to invest is always obvious. Looking forward, the best path is always uncertain, probabilistic. That’s the nature of investing. This year, I earned a low double-digit return.[1] Given almost 7% inflation, that means I modestly grew the value of my savings in real (inflation-adjusted) terms. Here is how that happened.

What helped:

1. Owning stocks, particularly banks and commodity producers. The S&P 500 rose by over 20%. Some bank stocks I owned, like Wells Fargo, rose by almost 60%. I

thought the economy would get better and financial firms and raw material producers would do particularly well in such a scenario.

2. Selling US bonds (betting prices would fall) in the first-quarter. I thought as the economy strengthened and inflation rose, bond prices would fall.

3. Owning certain commodities, like copper, which rose over 20%, amid a shift toward more environmentally friendly energy production, which requires a lot of copper.

4. Lending money to distressed borrowers. Early in the pandemic, there was a lot disruption and borrowers were forced to accede to terms favorable to lenders. As conditions stabilized, distress eased and prices rose.

What hurt:

1. Selling bonds after April. After declining in the first part of the year, bond prices stopped falling, even as inflation rose. The link between higher inflation and higher bond yields broke down.

2. Owning Chinese stocks. Chinese stocks lost about 5% as Beijing cracked down on entrepreneurs and entire sectors, like education. Certain popular stocks, like Alibaba, fell 40%. I had thought Xi was anti-civil liberties but pro-capitalism.

3. Emerging market bonds. I thought money printing in the US and high interest rates in emerging markets would favor emerging market bonds. Instead, bond prices in places like Russia fell, in part as Putin stationed troops on Ukraine's border.

4. Owning gold, which lost about 5% this year in part because investors moved into crypto instead.

Essentially, some of the things I did to protect against rising inflation (like selling bonds and buying gold) didn't work. I also took too little risk. After tracking my investment returns for years, I know I generally (but not always) make money. Yet, I've seen so many once-famous investors get wiped out because of hubris that I've always worried about my own hubris.

Looking Forward

The economy is strong and there are a lot of exciting, productivity-enhancing technological changes afoot (like mRNA vaccines). This is good for asset prices. Yet, the pandemic means:

1. **tens of thousands more (only 16% of Americans have a booster!) likely deaths,**[2]
2. **inflationary production and distribution disruptions and**
3. **central bank printing less money (tightening) to combat this inflation.**

Tightening is bad for assets. The challenge is basically how to own the good and protect against the bad. A key question is guessing how much the central bank tightens. I know this sound technical. Trust me, this *really* matters.

The price of an asset—a house, a stock, a bond—is set by supply and demand. Demand comes from many sources, but the biggest source of demand is, ultimately, the central bank for the simple reason that they have unlimited resources. The central bank creates zeros on a computer and money flows into the economy and assets. For a person like you or me to buy an asset, we need to earn money, which is much harder and can only shift so much. An individual can also borrow money, but ultimately that is paid back with income.

What Are Reasonable Expectations?

Markets are expectations. The price of Apple stock today incorporates expectations for how many iPhones they sell in coming years. For a price to change, there needs to be a shift i*n activity relative to expectations.* The price of suburban houses rose after Covid because there was an *unexpected* shift in demand as buyers fled cities.

The central bank (the Fed) has gone from saying inflation isn't a big deal, to saying it is. That happened in a few weeks. Is it possible they will soon say inflation is a BIG deal? Maybe. Expectations about their policy translates into numbers. If I lend the government money for two-years, I earn 0.65%. This interest rate is priced to rise to 1.5% in two years.[3] If the central bank raises interest rates faster than what they are now expected to do, this process will suck money out of markets, like stocks.
This graphic created for me by DGFX Studios capture the idea pretty well.

It's a matter of degree. Below (courtesy of Rose Technology) shows previous times the central bank has acted. History is a guide but is not predictive. I worry what we face may be *worse* than what has occurred in decades, because both stocks and bonds may loose value at the same time.[4]

How Big of a Hedge?

I have around 40% of my money in the stock market. Half that is outside the U.S., where similar stocks are not as expensive. In response to the risks described, I have significantly shifted my bets, as you can see below, selling bonds that should decline in price if the central bank tightens more than what they are currently expected to do.

It's a tricky because I am guessing what the central bank will do months from now. Between now and then we will get more information about Covid and inflation. *The central bank will only make a decision after this information is received, while as an* *investor I need to make a decision before*. I suspect that because we are in a new wave of Covid, the interruptions that have caused inflation to rise will persist and that this will force the Fed to act *faster* than they are expected to. Given that real (inflation adjusted) interest rates are deeply negative, moving them higher may cause losses in stock, bond and commodity markets, pain I am trying to mitigate. This isn't certain, but it's a risk, a risk big enough in my mind to justify the shifts I made.

1
These are NOT audited returns. I am keeping track on a spreadsheet, nothing more. Investment carries risk of loss. This is not investment advice. You can and will lose money investing, it is the nature of the game.

2
https://www.cdc.gov/coronavirus/2019-ncov/science/forecasting/forecasting-us.html. Also, https://www.nytimes.com/2021/12/18/us/omicron-booster-shots-americans.html

3
This is based on forward interest rate pricing, which is a technical topic that would require another essay. Suffice to say, these forward prices are not an opinion poll, it is the physics of how money is priced.

4
Note that these are TOTAL returns. If you strip out the cash rate, these results look worse, suggesting the risk of negative returns is even higher given that current cash rates are zero.

The Stories We Tell

We are wired for story. Stories can be conveyed in a cave painting, from the pulpit, a book or a podcast. Story is the way we share meaning and truth. Today's post is about key lessons that emerged from Season #3 of the Things I Didn't Learn in School podcast.

Our eight guests came from a range of backgrounds. As a reminder, they were: Adam Frankel, an Obama speechwriter; Rabbi Michael Friedman; Dr. Alexander Vanyukov, a Russian surgeon who re-purposed to treat Covid; Ray Dalio, an investor and author; Dan Zwirn, also an investor; Jim Comey, former head of the FBI; Tamara Chubinidze, a restauranteur and Nick Reber, a health-data entrepreneur. These stories were downloaded from Ho Chi Minh to Singapore to Kiev to Toronto to New York City.

While stories are infinite, the ones we remember often follow a structure. There is a beginning a middle and an end, of course. There is also a discernible pattern within those three parts.

Classically, the story begins with an event that knocks the main character out of the familiar. Think Odysseus released from captivity or Darth Vader capturing Princess Leia. This disruption forces the main character to respond, often against difficult opponents. Characters like Atticus Finch in *To Kill Mockingbird* or Jason Bourne come to mind. The hero digs deep and in doing so comes to see that they must rely on others, like Sancho Panza helping Don Quixote or Hermione aiding Harry Potter. Finally, the disruption is resolved and the main character is transformed, often wiser and more humble, like Raskolnikov confessing to murder in *Crime and Punishment* or Dorothy tapping the heels of her ruby slippers in *The Wizard of Oz* and waking up.

While life is messier than fiction, I saw the above rubric at work in our Season #3 conversations.

Lesson #1 – Expect your life to be disrupted.

Some of these disruptions are widely shared, like leaving home, becoming a parent or switching jobs. Others are more specific. Dr. Vanyukov's life went from being a heart surgeon with a relatively predictable work schedule to navigating Covid in a country where trust in government and vaccines is low. Investor Ray Dalio suffered every parent's worse nightmare, the loss of a child. Investor Dan Zwirn was suspected of having committed a terrible mistake, and only got cleared…years later. Jim Comey crossed paths with Trump.

In their own words:

"The bus can come up on the sidewalk and hit you." –Dan.

"Life is going to come at you. And it will give you wonderful things and it will give you terrible things in its way. And that's just..life." –Ray.

We also create disruption, like the way Nick is disrupting health care. I find it useful to sometimes stop thinking about whatever challenges I face and instead remember that everyone around me is dealing with their own disruptions. While disruption can feel isolating, it is a shared experience.

Lesson #2 – Our power comes from choosing how to respond.

This is an old idea.

In their own words:

"Choosing your attitude, you're choosing your energy …you have to know you have a choice fighting the battle," Tamara.

"Reputations are not under your control, only character is," Dan.

Reinhold Niebuhr offered the serenity prayer. God, grant me the serenity to accept the things I cannot change, courage to change the things I can, and the wisdom to know the difference.

Lesson #3 – People want to help.

Big problems are…big, too big for any single person to solve. We require aid and cooperation, which of course requires compromise and flexibility.

In their own words:

"If you need help, just ask. And that help can come from the most unexpected people and places. I couldn't even imagine that erstwhile soccer hooligans would be willing to run around helping grandmas," Dr. Vanyukov.

Tamara's help came in the form of tapping generations of culinary wisdom in her own family. "I was growing up in like a food competition, from two different regions," in Georgia, she said.

In his teenage years, Rabbi Michael Friedman decided **"Judaism could be a guide … for how to live a good life."**

Lesson #4 – You will get through your challenges and this will change you.

In their own words:

"Truly honest people are very, very rare. That is honest about themselves, about their biases, about facts," Jim.

The stories are there, if we ask and listen. Of course, if you are doing the telling, learn to "keep it simple and short; nobody ever wished a speech was longer," as Adam said.

Happy Holidays from the Still Press Team! Also, if you have someone who you think would make a great podcast guest, reach out.

The Barbell As Medicine

Happy New Year!

The most likely New Year's resolution is some combo of get-in-shape and lose weight; worship of a sculpted physique is at least as old as ancient Greece. That's why I thought a special treat would be a season #3 New Year's Day encore podcast, the link is here, with Matt Reynolds, CEO and founder of Barbell Logic. Matt's story is both about how to get stronger and how a phone can disrupt an industry.

Given the word "barbell" is in his company's name, it's perhaps unsurprising that Matt can lift very heavy things. For a while, he made a name for himself tugging trucks with his teeth, a link to body building's vaudeville roots. At that time, he was working as a teacher. Lifting was a hobby that, in his words, seemed "niche."

Then Matt got the idea he could share his understanding with regular folk. Matt began "proselytizing the value of strength as a quality-of-life improvement." You can see a video of Matt talking here. In our conversation, he tells the story of an elderly woman who could not easily get out of a chair when he met her but was slowly transformed by lifting, regaining functions she had thought were permanently lost. Hearing Matt's story made me want to lift heavy things, too.

There is an economic angle to Matt's story as well. There are roughly 340,000 personal trainers in the US. That's about three trainers for each of the U.S's 100,000 gyms. By definition, most of these trainers are mediocre, average. Matt's business is aimed at connecting clients with great trainers, giving coaches something they once lacked: scale. You film your lifting session and send it to your coach. Each of you can be anywhere.

Disruptions create new disruptions. An iPhone was the pre-condition not only for Waze but Matt's company. While the trade of what economists call "goods" (think factories) got disrupted decades ago, the services industry (like coaching) is only now getting going. Matt's company was founded in 2016. How many of those 340,000 trainers do we need if Matt's business does well? How many of the services—education, tax preparation, legal– can be offered for less cost and higher quality remotely?

Education is a biggie. There are certain foundational building blocks to social cohesion–a shared alphabet, religion, news source and curriculum. These institutions are all resistant to change, but under enough pressure, they give way. Yet, the core of my children's public education wasn't that different from what I experienced in the 1970s. To date, education hasn't been meaningfully disrupted.

Disruption occurs at the edges at first. You fire the local trainer and hire Matt. You skip after-school tutoring and do it yourself (better, cheaper) with Khan Academy. Bigger changes are likely afoot. Higher education, particularly the most expensive institutions, look like juicy targets. As always, something is lost, and something is gained.

Living through this much change is exciting and disorienting. The disorientation is big enough that I want to write a follow-up post on the topic more broadly. I'm also going to host an "ask me anything" for subscribers to get a better sense of what's on your mind. (Subscribers have already asked me to write an update on China and energy markets).

For today, however, revel that we all made it into another year. Also, we will not be publishing next week, spending the time instead lining up guests for season #4 of the podcast. Thanks as always for your support and interest.

Happy New Year from me and the rest of the Still Press team.

Jail Break

The tricky thing about investing is there are no fixed truths. There is common sense—buy low, sell high—but the game shifts because we shift. The market is people and our attitudes toward saving evolve, particularly after ruptures like depressions, wars and pandemics. This is evident in the “big quit;” millions of people suddenly leaving their salaried jobs, myself among them.

When I took this decision, I made some calculations. I will share them here, call it the cost of breaking free. **Knowing these calculations shifts money from something emotional and mystical to something quite simple, like tracking calories.**

My calculations differ from those of a typical Wall Street shop. Their calculations assume good things will happen, like that the stock market will rise. As a result of this assumption, they say you can spend down 4% of your savings every year. While it’s true that on average stock markets rise, it’s also true that they go through decade plus periods when they don’t and such a period *could easily overlap with the time when you try to jail break*. Don’t make optimistic assumptions, instead assume things will go badly and be pleasantly surprised if they don’t.

Here are the steps, along with a table and a calculator to let you do this yourself.

Step #1

The first calculation is the Steve Jobs calculation, which is the “knowing I will be dead soon,” as he described in his Stanford commencement speech. How soon? Find out.

I used the US social security administration actuarial tables, which suggest those of us in the US will generally be dead by age 85. By this measure, I have about 370 months left to live. Of course, there is a wide band around that mid-point. I put that band under the category or refinements (more on that below).

I suspect the pandemic forced people to consider their own mortality. Perhaps it also showed an alternative way of living. Many of you probably have some dream. Maybe it is starting a company or living in Italy or running for office or starting a family. If it’s holding the salaried job you hold, fine. If it isn’t, apply the Steve Jobs test.

Step #2

Know your run-rate, how much money you spend each month. You can drive yourself crazy trying to figure out this number. Don't. A very rough estimate will do.

The big thing you spend money on is the obvious stuff, like taxes, insurance, shelter, food, etc. Each month track roughly what you spend. Write it down. Average this over a few months and you roughly know your run rate. You can also ask others how much they spend.

Recognize this is what you spend *after* taxes. The typical US family spends $5000 a month. To keep it simple, round up and assume they spend $100k year or a bit more than $8000 a month. That means they'd need about $130k a year *pre-tax*. The more they spend the higher the tax bracket and vice versa. Just like you want to under-estimate investment returns you want to *over-estimate* your spending.

The lower this run-rate, the easier it is to break free. That said, you need to make BIG changes to make a difference. Switching from a latte to a black coffee won't move the needle. Moving from New England to Mexico, avoiding addiction or a messy divorce will.

Step #3

Multiply months left to live times your expenses. Take the $100k a year spending person with 370 months as an example. They need about $3.5 million saved to break free.

Adjust this number down for money already saved and up for debt owed.

If these calculations seem simple, people aren't doing them. The typical US family has about $100k in savings. This is in part because in the US there is not forced savings, a contrast to an Australia where there is. I think asking the average American to figure this out is quite a stretch. Maybe this essay can help.

A sample table looks like this.

Here is a calculator you can play around with this yourself, one in Google sheets (thanks my friends at Rose!) and one in excel.

Google sheets:

https://www.dropbox.com/s/81ncrbsiazfokbn/cost.of.jailbreak.calculator.v2.xlsx?dl=0

Excel:

https://www.dropbox.com/s/81ncrbsiazfokbn/cost.of.jailbreak.calculator.v2.xlsx?dl=0

To make the analysis more precise you can:

a) Adjust the lifespan, i.e. if you don't smoke you live longer.

b) Adjust income. How profitable will your break free occupation be? I assumed I'd earn zero. Too pessimistic?

c) Adjust inflation. This is a biggie. To be more accurate, assume expenses grow by the rate of inflation. That will make this analysis look even *worse*. Inflation is discounted to be about 2.5% a year over the next 10 years.

d) Assume asset growth. Asset prices do indeed rise over time, on average. This would make this analysis look better but given 7% current inflation, they need to rise a lot.

e) Include social security and Medicare. In the US, once these kick in, expenses fall.

f) Jail break without the cushion, recognizing that you are taking a bigger risk.

Other:

Market views:

Since I've started this newsletter, I've made three big decisions: avoid bitcoin, sell bonds and buy stocks. Since the time I shared those decisions in print, bitcoin is down 25%, bonds have lost about 4% and the S&P is up 22%. **These essays are not investment advice; I am sharing with subscribers what I do, when I do it.** I am moving around my portfolio more and will update that for subscribers later this quarter.

What I'm reading:

Non-fiction: *Unique, the New Science of Human Individuality*, by David Linden and *Morality*, by Jonathan Sachs. David published an essay in the Atlantic that struck me. "*It is possible, even easy, to occupy two seemingly contradictory mental states at the same time*." Agreed.

Sachs argued the foundation of "civil society," the sphere independent of politics and business, was anchored by a Judeo-Christian moral framework that believed in absolute, not relative truth. He argued that as this code weakened, society became more fragile.

Fiction: *The Age of Innocence*, Edith Wharton; *Les Misérables*, Victor Hugo. These are old classics and remind me both how much and how little things have changed. One of Hugo's characters says that the important question is "how to create wealth and how to distribute it." Many nations are having that same debate now. That's evidence in the US and also China's "common prosperity" push.

It is minus 9 outside today…time to go for a ski. Talk to you next week. Write with questions…I can arrange calls with subscribers.

The Tide Goes Out

If the rest of 2022 looks like January, most savers are in for some pain. Asset prices (stock indexes and bonds) are *down* and inflation is *up*. In real terms (after inflation), the typical saver has a lot less money, like about 8% less just this month. If this continues for the next six months … that is a meaningful decline in real wealth.

Here is an abbreviated version of what is going on:

1. The central bank (the Fed) is slowing the rate at which they print money. Less printing = less demand for assets = lower prices.
2. Inflation is rising, due to a combination of strong demand and a disrupted supply chain. China, a critical node, is disrupted due to zero Covid tolerance and vaccines that don't work well versus Omicron. Chinese ports may be impaired *for years*. That suggests the US central bank might need to raise interest rates *a lot* to slow demand because supply will struggle for some time. Right now, the bond market is betting the Fed will lift rates 1% this year. If market expectations shift higher, stocks will fall further.
3. Russia may invade Ukraine, which, depending on exactly how they do this, may drive commodity prices up further. Russia supplies raw materials to the rest of the world. Much of what we call inflation *is* commodities.
4. The Biden Administration is floundering. Afghanistan + Covid + inflation = Republican sweep of November elections and an end to additional fiscal stimulus.

The question, as always, is what to do. I will share my specific asset allocation answer with subscribers later this quarter. I will also host an "ask me anything" (AMA for hipsters) for subscribers **Sunday January 30, at 2 pm New York City time**. I'll send out a separate subscriber-only note the day before as a reminder and with call details.

Stocks

A stock has two moving parts, the earnings of the company an investor owns and the price paid for those earnings.[1] The earnings of many, not all, companies are likely to grow over the next year. The problem is with the high price investors pay for those earnings.

A combination of zero interest rates and high inflation meant investors lost money holding cash, so many, particularly households, bought US stocks. The chart below from Yale Professor Robert Shiller shows one perspective on this. It exaggerates how bad things look[2] but is still useful. The average PE over the long term is around half what is on the chart, suggesting stocks are roughly 40% or 50% overvalued.

So an investor ought to sell, right? The answer is "it depends." How big holdings of US stocks are relative to other assets held, age, where assets are held (taxable or not) all factor in. It's certainly possible stocks fall *a lot more.* If I had all of my wealth in crypto and tech stocks (I don't), I'd be concerned.

Taxes

While I've discussed asset allocation before here, I have not addressed taxes. In most of the world, savers are taxed twice. Many consider the first set of taxes, on income, but not the second set of taxes, on savings. **I am not an accountant and this piece is neither investment nor tax advice,**[3] however, I will share my thoughts with you and you can decide what to do yourself. In the US, there are different levels of what are called capital gains taxes, basically taxing your savings. There are also taxes on dividends, which can be qualified (taxed like capital gains) or non-qualified (taxed higher, like income).

The chart below shows the periods of time since 1970 when US stocks have lost money and a horizontal line at the highest level of capital gains, 20%.[4] As you can see, there are four periods (1975, 1987, 2001 and 2008) where you would be better off selling, paying the tax and trying to invest later (if you can time it right). Another example is 1929. There are lots of times stocks fall and, factoring in taxes, it was a bad time to sell.

This is a function of compounding. If you benefited from a big run up in stock prices and you sell, you write a check to the government. This means you are now *compounding off of a smaller base*. If stocks bounce, you are bouncing with less money, which means you need a bigger bounce to get back where you started. (If you like these charts, thank Rose Technology, a start-up that is fantastic at visualizing economic data).

So the question is not are US stocks overvalued, they are. The question for taxable investors is are we on the edge of 20%+ correction? My answer is: maybe, but I'm not sure because the earnings (in aggregate) will be OK. There is a bigger question that I will address at a later time which is this: years of stimulative policy have driven asset prices so high that bringing them back to earth will depress spending.

I've taken steps to protect myself and will share them with subscribers. Step #1 was holding a small exposure to tech to begin with. Mine was about 3%. Many institutions have also avoided holding a lot of US stocks. Households, however, disagreed, and have driven the last two-years of rally. What will they do next?

Constraints

I want to provide a follow up to last week's post, Jail Break. I realize, particularly for younger readers, the title is a bit disingenuous. In truth, you never break free; rather, you constantly negotiate constraints. That's true in two basic life vectors, work and relationships.

Consider the relative merits of working for a big corporation or yourself. A corporation offers scale. Scale widens your circle by putting you in contact with new people, makes you part of something bigger. It also embeds you in a bureaucracy. Managing your boss, negotiating colleagues, budget and salary become the work, in addition to the actual work. Tired, you leave ("jail break") and start your own gig. Now you have to build an idea from scratch and there is no one to blame but yourself for the outcomes. Relationships obey the same physics. Being monogamous creates constraints, dating (which I last did in the 1990s) creates different constraints. Constraints are inescapable, chose them well. Life, as Chekhov said, is a vexatious trap!

Russia and Ukraine – A number of readers asked me about this. In brief, if rule of law matters, Russia can not violate Ukraine's borders. That's the Western perspective. If rule of law is a mushy concept, what matters is power. If the US isn't willing to put troops on the ground, Russia can seize territory. The gap between Russia and the West regarding rule of law began opening up in 1215 when the Magna Carta came into being and continues to this day. In terms of the markets, invading is terrible for Russian productivity. The cost of capital goes up and talent gradually leaks out. I spoke about this before here.

Reading and watching:

Watching: *Passing.* You can read about the film here. I don't think this film could have been made 20 years ago. Our culture is in motion and great art moves the conversation forward. *Soros*, a documentary about the man, who I have met a few times. It captures him well.
Reading: *Undermoney* and a bit of *Ulysses*. Undermoney is a new word. As the author, Jay Newman, defines it, it is "money which is unknown publicly but that controls individuals and events." It's also the 100-year anniversary of James Joyce's work. I've started but never finished the book and, in his honor, dipped my toe back in.

I thought about today's post while walking here:

1
Put aside dividends, which are paid out of earnings.

2
Shiller is using a 10-year average of earnings…which means that if earnings have picked up over recent years, this measure will decline and look less scary. Investors often look at what earnings will be in the future, which would bring the PE down further.

3
Investing is RISKY. *You can and will lose money*.

4
If your income is less than $40K, you don't pay capital gains; from $40 to $440k, you pay 15%; above $440k, you pay 20% (based on Google).

Tightening and War

There are times when it is easier to make money investing and times when it is harder; this is a time when it is harder. Investors (savers) need to simultaneously navigate a) less Fed money printing and b) a potential war—while not losing sight of the big picture, which is a transformative wave of innovation.

These forces can work in *opposite* directions. For instance:

a) Removing liquidity (tightening) hurts bonds, prices down, yields up (which is what has happened this year).

b) Invasions fuel uncertainty, which drives bond prices up in places like the US.

c) Simultaneously removing liquidity **and** an invasion is bad for stocks (which are negative year-to-date).

d) Tech innovation is good for stocks, particularly the companies doing the innovating—but a tech revolution is a longer-term trend that can be swamped by the short-term.

e) Green investing aims to cut fossil fuel investment, war with a major energy supplier (Russia) encourages increasing non-Russia fossil fuel investment.

To make money, an investor needs to balance these forces just right, which is delicate work. I am sharing how I am navigating this, for you to take or leave. **THIS LETTER IS NOT INVESTMENT ADVICE**.[1]

Ukraine

Ukraine is really complicated. You could argue forever about what its borders should be, based on competing claims from Ukraine, Poland, Russia and others. Given that, claiming the current border isn't a true border, which in essence is what Russia is claiming, creates utter chaos. There are potential border disputes all over the world. If you open up one border dispute, you risk opening up many, including, by the way, ones between Russia and the Kremlin's ally, China.

Culturally, there is a nationalist resurgence afoot in Ukraine. When I was a reporter in Russia in the early 1990s, I went by bus from Russia to Ukraine. Almost everyone spoke Russian. Now Ukraine is linguistically split, more like a Canada (English, French) or Switzerland (French, Swiss-German, Italian). But in Ukraine the split has happened relatively quickly; it accelerated following Russia's 2014 Crimea invasion. Ukraine is more western the more west you go and more eastern the more east you go, which leaves it vulnerable to civil war.

Economically and politically, Ukraine has not been successful. It is one of the few countries that is **poorer than it was before the Soviet Union fell apart**. The culprit seems to be a combination of uncompetitive legacy Soviet industry and corrupt leadership. Corruption is a plague in many countries, including the US. But Ukraine is really corrupt, roughly as bad as Russia.

Competing Perspectives

The perspectives of the main players look almost irreconcilable. The bottom line is Russia has vastly superior military force and can seize Ukraine at will and the US is trying to convince Putin he will pay a high price for doing so. It is very risky.

Russia's Perspective: NATO is an aggressor and the CIA is fomenting opposition to the Kremlin in the historical bedrock of the Orthodox world, Kiev. The Biden Administration is weak, exhausted by war and, as evident in Afghanistan, won't stick by allies. Ukraine's leadership is hostile and weak. It's time to seize Ukraine before it slips into the hands of the West.

Ukraine's Perspective – We have rapacious neighbors (including Germany) and a bloody history, including an administered famine under Stalin. The latest of many invasions began in 2014. Russian forces have killed thousands and the KGB successor tried to murder a Ukrainian President. Give us anti-tank and anti-aircraft missiles and we will defend ourselves. Our institutions are weak but under the leadership of Zelensky improving. We gave up our nukes in 1994 under the guarantee our borders would not shift.[2]

US Perspective – Where exactly is Ukraine? Our critical problems are inflation and COVID. Putin is a thug who we would have liked to ignore, but we can't if Russia is invading a country. NATO is a defensive force,[3] that was dying until Putin's behavior resuscitated it. Given that we won't put soldiers on the ground or use our Air Force, we can't stop an invasion.

Europe (Germany) Perspective – We like Russian energy but don't want impoverished Ukrainian refugees pouring into Poland. The best thing to do is negotiate with Russia. This will take time, but all of the European Union is just one big negotiation. Russia isn't part of any significant European institutions and should be.

Charts

The charts below illustrate the above. (Rose Technology, an incredible data-visualization start-up, makes them). Russia exports oil, Germany uses that to build machinery. Ukraine exports more agricultural goods and oil products. For the US, trade is simply less important.

Ukraine is poor and corrupt, only slightly less corrupt than Russia[4].

Russia has massive foreign exchange reserves, a huge trade surplus (thanks to high oil prices) and low debt. The US is the opposite. This makes Russia harder to sanction.

How to Invest?

I am a) holding less stocks (particularly in Europe) b) a lot less bonds and c) more commodities or commodity linked stocks. Here is my logic:

· **Stocks.** While earnings are going to be strong, price to earnings ratios (the price you pay for those earnings) are high, particularly in the US, and equities globally are quite correlated. Tightening isn't good for PEs, invasions are worse. *Implication: lower equity exposure, particularly in Europe.*

· **Commodities**. In the event of an invasion, aggressive sanctions are possible, including on raw material exports. Oil could go well past $100. *Implication: own more commodities and commodity producing companies.*

· **Bonds.** Commodities are inflation. If we get a squeeze, inflation risks get worse, the Fed needs to tighten even more. *Implication: hold less bonds, particularly short-term bonds*.

· **Russian Assets**. Dirt cheap IF they don't invade, un-investible if they do. The price to earnings ratio on Russian stocks is … 6! The price to earnings on US stocks is…23. If Putin invades and sanctions are applied not clear you can get your money back. *Implication: avoid Russian assets.* Tragically, disruptive foreign policy is starving Russian innovation of needed cheap capital.[5]

· **Tech** – Less an investment implication than a dynamic: a conflict can be cyber as well as physical. Tech also creates transparency where before there wasn't, like Twitter shots of Russian troop movements.

What might make this go away? Maybe deterrence plus throwing Russia a bone, like agreements over military exercises? War seems more likely. Any troop pull-back results in a massive rally in Russian assets.

OTHER:

Next Podcast: Next week, we release Season #4 of our podcast. Our first guest is Jonathan Yorke, author of *Into the Woods* and a genius on story, both their immutable structure and why they exist. I think you are going to love this podcast, which Still Press Producer Dave Manahan is putting the finishing touches on now. Here is an out take.

John Yorke Storytelling Preview

Ask Me Anything: Today at 2 PM Eastern. Subscribers should have all the details already.

Parting Images: As I researched Ukraine this week, I reflected on my own early experience with Russian tanks. I was 25, living in Moscow and witnessed enormous tanks fire on civilians. Terrifying. My friend (and podcast guest!) Paul Fetters took this picture after the hostilities ended.

I thought about this week's post while walking along the beach shown below, snow mixed with sand. It is single digits in Connecticut. Russian gas heats Europe.

1
Investing is risky. You can and will lose money. A reader asked me about my background. In addition to the information cited above, I started as a reporter in Russia in the 1990s. During my 20+years on Wall Street, part of the time I focussed on Russia.

2
Budapest memorandum, 1994.
https://en.wikipedia.org/wiki/Budapest_Memorandum_on_Security_Assurances

3
NATO moved troops to the Baltics after Russia invaded Crimea.

4
We inverted the rankings from Transparency International, higher is worse.

5
I wrote about this in The Cost of Invading and The Talent Skedaddle.

The Physics of Story

I like a good framework. For instance, an equity (a stock) has just two moving parts, earnings and the price paid for those earnings. Earnings, in turn, are spending. A framework puts individual observations, like the price investors are willing to pay to own a company's earnings, into logical context.

Given my bias, it was only natural that when I wrote my second book I tried to find a framework for story. Season #4 episode #1 (click here) guest John Yorke wrote the best book I've read on the topic, *Into the Woods*. According to John, story has a physics, immutable rules. Understanding his framework can help you understand any story, be it a film, book, origin myth or politician's speech.

Structure

According to John, every story has three parts: an inciting incident or disruption, a struggle and a resolution**.** This is as true of Shakespeare as it is Harry Potter. Structures can get more intricate, but even the more intricate ones can be reduced to these three parts.

John's classic illustration is Jaws. What could be more disruptive than a massive shark devouring, in the opening scene, a fit, young woman? I saw the film when I was 8 and still remember scenes vividly. At the end, of course, the shark dies. In between, there is a life and death struggle, unlikely alliances are formed.

A sales pitch is another version of the same. When I worked at a bank on Wall Street, in retrospect I realized volatility was our shark. If markets were calm, there was less incentive to act and, as a result, less incentive to do a transaction with the bank.

When it comes to politics, John contrasted Hillary Clinton's storytelling with Trump's. Her slogan was "better together," his "drain the swamp." Like Jaws, "drain the swamp" is visceral. I imagine a toxic brew of malarial mud. "Better together," as John said, is "art house film." The simpler the story the broader the reach.

For additional perspective, I asked the people at Rose Technology (to look at the Google trends around the two phrases.

To the degree searches reflect emotional impact, John's instinct is accurate. Trump had better "shark." To be sure, it is possible to build compelling narrative out of falsehood. Putin's shark is NATO. While in reality a defensive force, Putin portrays NATO as an *offensive* force threatening Russia. Because Russia has been unsuccessfully invaded twice (Hitler and Napoleon) and successfully once (Genghis Kahn), threats of invasion are a compelling shark.

US political extremes have their own sharks. The Left's shark is "oppression;" the Right's is "liberty." Wherever you fall in your political predilections, you are being fed a story, so best understand how they work. After digesting John's wisdom that I began to look at the news differently.

The Best Stories

While stories can be used to manipulate, the best stories serve a purpose, they illustrate a truth, even if truth is ever shifting. Each generation is tying to share key lessons for the next generation. Love stories are about finding a mate, clearly important for the tribe to continue. As our definition of relationships evolve, stories must too. War stories remind us of how awful our penchant for violence is.

If a story is exceptional and you get lost in its magic and the structure disappears. That there is nonetheless a structure at work was not something I was never taught in school. John suggests there is a resistance to suggesting stories follow a formula, as if it somehow hollows out the art. I don't see it that way. To the contrary, just like with the framework for a stock, the structure provides coherence.

What's Going on In Markets

The basic dynamic is simple. The Fed is going to remove liquidity and the West is doing everything it can to dissuade Putin from invading Ukraine. At the same time, the economy is growing quickly.

So far, the bond market is responding to the Fed, not the Ukraine invasion risk, so yields are moving higher. I will give a more detailed update of my positions a bit later in the quarter. A short version is here, an update from my Wins and Losses post. THIS IS NOT INVESTMENT ADVICE, instead it is transparency on how I am navigating the markets for you to take or leave.

1. I remain outright short bonds in the US and have moved this short further out the yield curve. The Federal Reserve (central bank) is now expected to raise rates about six times this year.
2. I have less overall equity exposure (about 25% down from 40%), selling positions as they went negative (such that there was no tax obligation). My overall exposure to US stock *indexes* is now negative 4%, though I am on net positive US stocks given long exposure to banks and oil companies.
3. I have increased overall commodity and commodity equity exposure, now up to 17%. Here, I have been picking individual stocks to create a customized exposure that an index can't offer.
4. My overall (unaudited) returns are about zero for 2022. As of this writing, the US stock market was down about 6% and a 10-year US government bond is down about 3% year-to-date.
5. I believe the Fed is going to tighten, US stocks and bonds will fall further, there will be a huge benefit to owning safe havens that don't fall (thus the stock picking) and at some point, I'd guess in roughly the middle of the year, inflation pressures will start to ease and there may be a time to buy US stock indexes and bonds again.
6. For people who aren't actively trading (and I wouldn't recommend that you do) the single simplest thing to do might be to have your dividends go into cash, as opposed to be reinvested automatically in the stock market. When the Fed has stopped its tightening, it's probably a better time to buy, though of course timing this is extremely difficult.

7. Regarding Ukraine, the invasion risk is still high, but it may be getting harder for Putin to invade in part because the West knows his tactics too well. This is sort of what happened to Trump. Initially his “shark” wasn’t well understood, so it worked well. As his moves became better understood they also became less effective.

8. Regarding the economic recovery, I am currently in Cyprus. Outside my window, I’ve counted many cruise ships sitting empty. They have to park them somewhere. This is visible evidence both of what true business risk looks like and also that some parts of the economy remain completely dead and will bounce very hard when Covid finally (years from now?) disappears. This monster is parked right outside my door.

Other:

What I am reading:

Energy and Civilization by Vaclav Smil. Another “framework” is man’s search for energy. Our legs and arms are relatively weak. Mechanical advantage magnifies our strength. Today’s inventions, like this computer and Substack and high-speed connection I write with, come after generations of brutal work to learn to harness energy. Think hunter-gatherer→farmer→dam-driven mill owner→gasoline driven tractor driver where now one person can do the work that used to require hundreds and hundreds. That is productivity. Today’s concern about global warming comes after hundreds of thousands of years of being concerned about having enough to eat. Many of us have forgotten what it is to feel hungry. Alleviating that sense of hunger was perhaps the original motivation to develop fossil fuels.