February 1, 2021

"I am still making order out of chaos by reinvention."

– John le Carre

Dear Client,

The 4th quarter of 2020 began with tremendous anxiety and divisiveness around the Presidential election. Investment markets reflected that anxiety. The S&P 500 was down 2.8% in October, following a 3.9% decline in September. Implied volatility climbed as everyone seemed willing to pay up for market crash insurance.

When November 3rd arrived, global stock market anxiety was in the rearview mirror. Election Day passed and a pressure relief valve seemed to open. Divisiveness be damned! Stocks decided to party like it was 1999. The S&P 500 climbed 10.8% in November and finished the quarter up 11.7%. However, other major asset classes were not invited to the party. For the quarter, Gold and the Barclays Aggregate Bond Index both finished barely up (roughly 0.7% each). Interest rates moved higher: the yield on 10-year treasuries rose from 66 to 93 basis points. This precipitated a decline in long term bonds of 2.7%.

The Grey Owl "all-weather" portfolio was up 4.8% for the quarter. We entered Q4 with stock related exposure at 37%. Since then, we have aggressively added stock related exposure which currently stands at 63%. Fixed Income exposure is currently 23%, three-quarters of which is in short-term and inflation protected bonds. We cut our position in Gold from 10% to 3%.

Going Forward

Markets continue to ignore the Covid pandemic and risk taking has been handsomely rewarded. Aided by epic government stimulus and a massively expanded Federal Reserve balance sheet, investors decided to look beyond the crisis and price assets based on a full economic recovery. Although a full recovery has yet to be achieved, the rate of change dynamic is decidedly positive – growth is accelerating.

As we move into the first half of 2021 risk assets will likely respond positively to strong comparisons with Q1 and Q2 of 2020. The US economy will likely experience unprecedented year-over-year growth. March through June of 2021 will most likely witness some of the greatest year-over-year economic growth and inflation acceleration ever measured. In fact, the Atlanta Fed's GDPNOW already shows a *fourth* quarter 2020 growth rate of 7.4%.[1] After a very brief leveling off, that is only going to accelerate into the 2nd quarter.

Our earlier work with signals from credit spreads and gold led us to process refinements that now even more tightly link our investment stance to economic regimes and allow us to key on shorter time frames. To grossly simplify, when growth and inflation accelerate, we need to invest heavily in risk assets. When growth and inflation are likely to decelerate, a greater allocation to cash and hedges is warranted.

In one of the most salient indications of "risk-on," credit spreads continue a relentless narrowing. They are currently lower than at any point since early 2018. Thus, as highlighted earlier, starting in the fourth quarter of 2020, we began increasing our exposure to risk assets and continue to do so.

Given the environment, we spread our equity investments across individual names, as well as cyclical sector exchange traded funds (ETFs) we believe will outperform during the coming period of growth and inflation. The "all-weather" overlay persists, but "risk-off" assets are near their lowest percentage allocation that fits our overall model.

Secular Growth Trends – Embracing New Themes *Before* They Mature

In addition to keying more on economic regimes and adjusting our exposure to "risk-on" and "risk-off" assets accordingly, we are also more willing to embrace new themes before they mature. Traditional value investors want to see a business go through several economic cycles before they invest. With instantaneous access to information and greater competition to deploy capital, that approach has proved less effective over the past decade. Today we see two opportunities in nascent areas with significant secular growth tailwinds.

<u>Cannabis.</u> We are currently in a period of significant growth for businesses in the newly legal cultivation, packaging, and distribution of cannabis. State after state continues to decriminalize the use of cannabis. And, with the recent federal election it is more likely that legislators will relax regulation at the federal level. MSOS provides diversified exposure to this theme in an ETF package.

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[1] https://www.frbatlanta.org/cqer/research/gdpnow

Bitcoin. It is hard to conceptualize because we have all lived our entire lives in a US-dollar-centric world, but money, particularly fiat money, is just an abstraction. The taxing authority and military might of the US government back the value of the US dollar, so it is a uniquely sturdy abstraction. But, it is weakened by the same government's profligacy, the sometimes-purposeful attempts to devalue the currency against other countries' currencies, and the willingness of the Federal Reserve to fabricate new currency to supply liquidity to markets during periods of stress. At the same time, advancing technology and human innovation have created the opportunity for wholly new monetary abstractions that can serve as increasingly compelling alternatives.

Why Bitcoin? There are other crypto currencies, but Bitcoin has proven durable. It has already survived for almost a decade and has recovered from a significant (life-threatening?) selloff. Bitcoin's value is already meaningful with a market capitalization measured in the 100s of billions of dollars. It is over 50x bigger than direct crypto monetary competitors. This is critical. Like Facebook or Google, currencies benefit from network effects and thus are winner-take-most markets. As the existing market leader, Bitcoin is the likely winner in the digital currency space. Yet, still very few people and institutions own Bitcoin and thus it can grow significantly in value as more and more adopt it as a store of value. In the last few months, some of the largest hedge funds (e.g. Paul Tudor Jones), insurance companies (e.g. Mass Mutual), corporate treasuries (e.g. Microstrategy and Square), and college endowments (Harvard and Yale) all made investments in Bitcoin. The more people and institutions that buy into the abstraction, the more valuable the abstraction, and the more other people and institutions will be willing to buy in – the ultimate pro-cyclical feedback loop. GBTC is an exchange traded trust that provides exposure to Bitcoin via publicly traded markets.

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2020 was challenging for so many and on multiple fronts. Grey Owl Capital Management's all-weather approach performed well to protect capital – our first objective. But, in the compressed nature of market time in an extraordinarily high volatility environment, we missed opportunities to grow and compound capital. Today, our approach is more responsive and timely with an even greater focus on using the current economic regime to inform our investments. From chaos comes reinvention and improvement. We look forward to the possibilities of 2021 and beyond.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,
Grey Owl Capital Management
Grey Owl Capital Management, LLC