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Vol. 44, No.1

QUARTERLY INVESTMENT OUTLOOK

JANUARY 2021

SUMMARY

- We view the recent release of Pfizer's (core holding) COVID-19 vaccine as a potential "game changer" for equity investors. Our analysis considers the fact that widespread public availability of the treatment will probably not occur until the Spring 2021 at earliest. Health care workers are already receiving the vaccine.

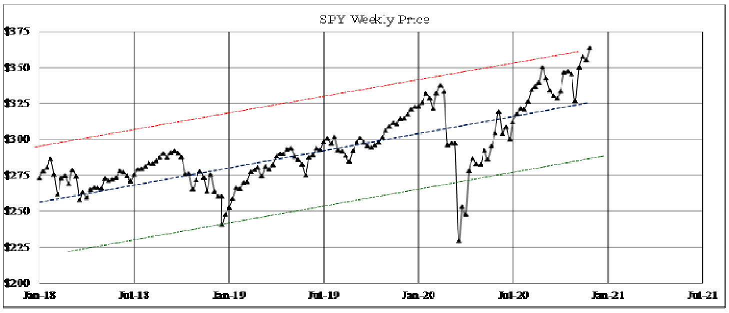
- The pandemic has weighed heavily on several value sectors including Financials, Energy, Industrials and Materials. Despite the general level of market overvaluation as shown by our analysis of the Buffett Indicator, the markets uptrend is intact. Other positive market factors are the steep yield curve, tight credit spreads, low yields, a weak dollar and global recovery. The recent breakout of Emerging Markets to a 10-year high validates our cautious optimism for a continuation of this bull market into 2021.

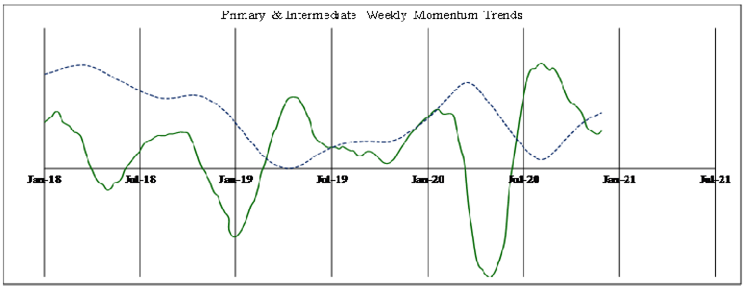
- Rising yields in 2021 should contribute to an increase in money velocity and ultimately assure a sustained economic recovery. While the pace of recovery will likely remain tepid, due to both sluggish gains in both the labor force and productivity, inflation should rise and may exceed the Fed's 2% price target. Rising oil prices should gradually feed into the headline data for consumer prices.

- According to a recent Horizon Kinetics 3rd Quarter Summary, the transition from fossil fuels to renewables will likely take longer and cost more than is generally believed. In order to achieve net zero emissions by 2050 liquid fuels consumption is projected to decline by roughly 10 mil. bbl/d by 2030. Under a business-as-usual assumption global liquids consumption will likely flatten out at 100 mil. bbl/d over the next 10 years.

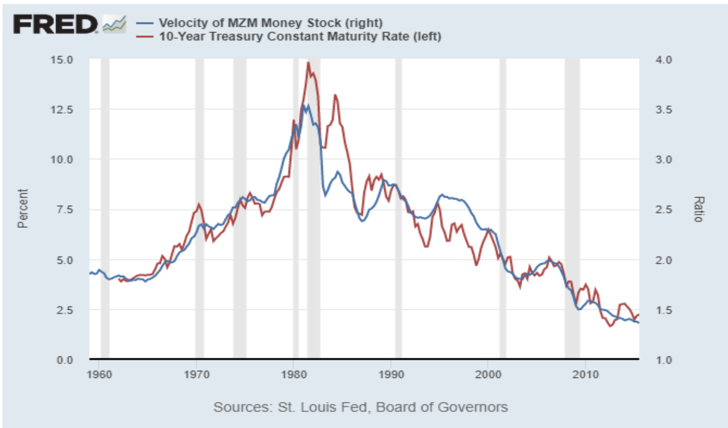
- A 65% decline in oil rigs ytd all but guarantees oil production will decline well into 2021. With oil demand expected to recover to pre-pandemic levels by 2H 2021, the market should be in a supply deficit throughout next year according to Goehring & Rozencwajg's latest forecast.

- As shown in the chart to follow our weekly momentum studies show the S&P 500 is challenging the upper trend line which has served as major resistance over the past 5 years. Meanwhile, price momentum appears to be turning higher which is bullish for equities over the intermediate horizon. Global ex-U.S., not shown, has a much more constructive price/momentum profile.





REFLATION AND MONEY VELOCITY - THE MISSING LINK



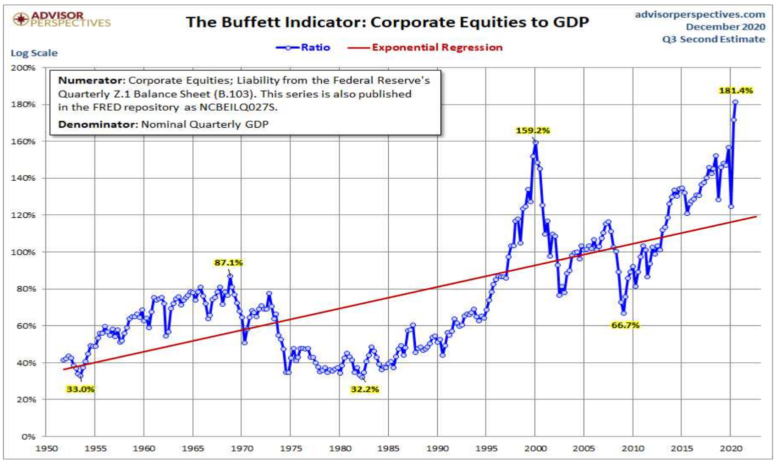
As shown in the chart above there is a strong positive correlation between money velocity and 10-year treasury yields. Money velocity increases as money supply is created in the fractional reserve banking system. Increasing loan demand is the key driver. As money supply increases it drives inflation expectations higher. This changes behavior as individuals/businesses raise their spending anticipating higher prices in the future. Interest rates/bond yields move higher and a self reinforcing business recovery takes hold (higher GDP). Money velocity and bond yields are linked together and move up and down with changes in inflation expectations.

Money velocity and bond yields peaked together before the onset of the 1982 recession. Since 1982 velocity and yields have trended lower. Our incipient inflation thesis is predicated on a global recovery and higher bond yields. However, we acknowledge that central banks have a vested interest in maintaining low yields. John Hathaway, noted precious metals investor, in a recent essay entitled "Gold the Simple Math" refers to a Wall Street Journal op-ed quote by former Fed Governor Kevin Warsh, describing the dilemma the Fed currently faces. To quote Warsh "If the economy does well in the coming quarter, I expect the Fed will expand significantly the scale, scope and duration of its asset purchases. If the economy weakens or financial markets fall, the Fed will do even more. This is what political scientists call path dependency. When an institution sticks to a path for long, it finds its options limited, detours difficult and exists infeasible." Noteworthy, is that the Fed currently is actively purchasing $120 billion of treasuries and mortgages every month! In effect there is little difference between fiscal and monetary policy. This monetization of fiscal policy is slowly becoming a norm and supports our incipient inflation thesis.

<u>THE BUFFETT INDICATOR IS AT AN EXTENDED LEVEL SINGNALING A CAUTIOUS INVESTMENT OUTLOOK</u>

The Buffett Indicator is designed to identify periods in which equity investment risk is high (today) and when risks are low (2009). It is a valuation measure that fluctuates between +60% (stocks overvalued) and -30% (stocks undervalued) on a detrended basis.

The Buffett Indicator on page 4 is a variant of the original which uses the Wilshire 5000 Stock Index as a numerator in place of corporate equities (liability from the Federal Reserve's Quarterly Ƶ.1 Balance Sheet). The denominator is quarterly GDP. The current reading for November 2020 is 160.4% which is the highest since 1971, and exceeds the 136.9% reading in 2000, the height of the dot.com boom. Dshort.com has detrended the indicator and converted the deviations from trend to standard deviations. Using this technique the November 2020 measure at 160.4% is at 73% in standard deviations versus 96% in 2000. This means that while the present indicator reading is alarming for investors, it is not yet at an extreme. The Buffett Indicator would have to decline to -24%, (-1 standard deviation) to be considered as giving off a bullish signal to equity investors.



With the market overvalued what does that mean for our investment strategy? Since our firm's founding in 1978, we have always focused on value investing. This involves buying equities that are strong franchises, but are temporarily out of favor. We try to avoid value traps which typically result from either a fundamental change occurring within a company, or an external macro trend that becomes a headwind. Despite the market being overvalued, our core holdings collectively trade at roughly a 30% discount to their fair value. We model this valuation metric quarterly, as new company data becomes available. The 30% discount is our "margin of safety" and its large deviation is a testimony to the degree to which the laggard value style has been shunned by investors. As such a catch-up period where value outperforms the market is long overdue, and we believe is underway!

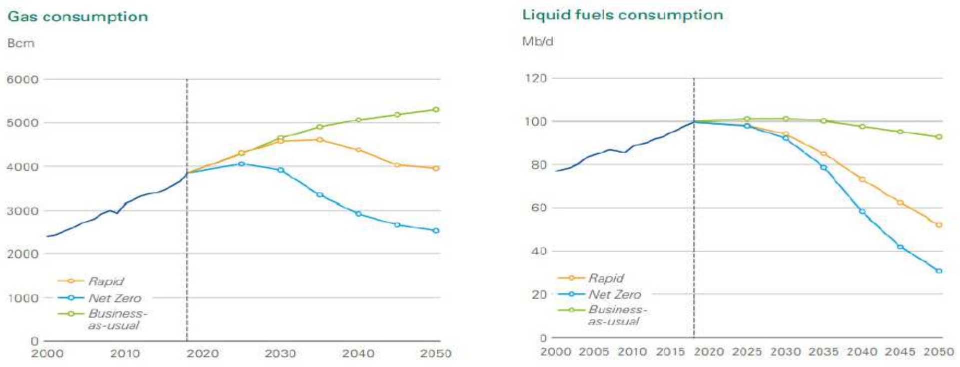
BUILDING A CASE FOR RENEWABLES

A recent study by Horizon Kinetics LLC suggests that oil and natural gas will likely remain a major source of energy over the next 20 years. This despite the fact that many producers have announced the goal of being net-zero carbon emmissions generators by 2050, or sooner. In order to reach net zero, companies will build scale in renewables, hydrogen power, carbon capture, and storage. The Horizon Kinetics report forecasts renewables demand should outpace that of gas alone by more than 3X by 2030. Gas demand should outpace that of nuclear, oil and coal through 2030. Under the net zero assumption, oil demand should decline roughly 10 mb/d between 2020-2030, with gas demand measured in billion cubic meters holding flat.

One of the major problems with renewables is the power source is interruptible as compared with fossil fuels. As such they cannot operate alone without a backup fossil-fuel energy source. Moreover, they can't be manufactured without fossil-fuel as part of their content. The facts show that onshore wind power is available only 25% of the time, with offshore availability at 40%. Utility based solar in the

U.S. also has an operating utilization rate of 25%. Base-load power, or the amount that is always required, cannot be sporadic, therefore the necessity of fossil-fuel as a reserve. Noteworthy is that natural gas demand in June/July reached an all time high despite the pandemic and U.S. recession!

The Horizon Kinetics report references a Deloitte study that suggests that solar/wind prower would have to be 3x-8x global peak energy demand to ensure the equivalent of base load capacity to be maintained. In order to meet the zero-emmissions goal by 2050 wind/solar capacity would have to be 3x present base load.



Source: https://www.bp.com/en/global/corporate/energy-economics/energy-outlook.html

The manufacturing process for producing renewables is highly carbon intensive. For example silion dioxide, used in semiconductor wafers for solar panels, is heated to 4,000°F melting point, which requires fossil fuels. A 2 mw wind turbine's blades are 160' long and are fabricated from fiberglass, which is glass reinforced plastic made from petroleum.

A final obervation highlighted in the HK study involves the need to upgrade the U.S. electric grid. This involves upgrading transmission equipment and distribution lines which have already exceeded their 50-year rated life expectancy. Over the next 20 years this "grid upgrade" could require an estimated $338 billion in investment. One reason for the huge expenditure is the grid was intially designed to distribute power from a central location, whereas renewables are distributed along the edge of the grid, requiring a larger distribution network.

Another important fact to assess in building out renewable power is battery storage. We expect continuing improvement in battery efficiency, but the maufacturing process is extremely carbon intensive. Also it requires the use of rare earth elements whose supply may not be secure in the future. Other complicating factors involve environmental permitting for the grid and the ultimate problem of reclamation and disposal of toxic materials common to the renewables manufacturing process.

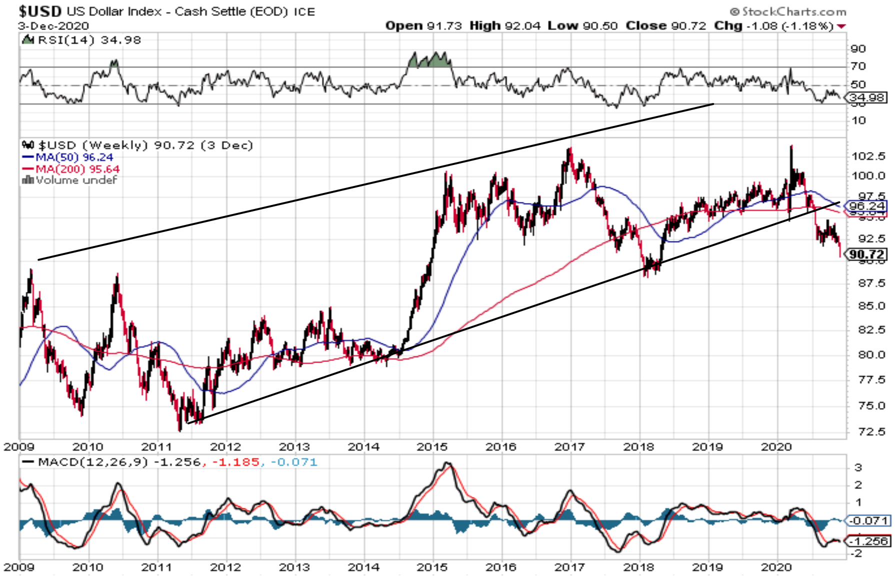
OIL PRICES ARE HEADED HIGHER INTO 2021

There has been a virtual collapse in oil rigs working over the past 12 months. From over 674 oil rigs in the U.S. a year ago, the latest Baker Hughes Rig Count (11/13/20) shows 236 oil rigs in operation, a decline of 65% yoy. Permian Basin decline rates average 27% per year according to studies done by noted petroleum geologist, Arthur Berman. Berman noted in a June 2020 update on **oilprice.com** that newer drilled wells have higher decline rates due to better drilling and completion technology. Berman noted it is absolutely critical to keep 500 to 600 rigs operating all the time--to replace roughly 30% of lost output due to depletion. He estimates it would take several years to increase the rig count to maintain 2019 output levels. The completion of DNC (drilled but uncompleted inventory) can make up some of the difference, but completion costs are 50% of total well costs. Berman estimates U.S. production at roughly10 million bbl/day should decline to 8 million by the 2H 2021. As such oil prices are set to move higher. OPEC+ simply can't make up for a prospective 2 million bbl/day decline in U.S. output!

THE DEATH OF THE DOLLAR

As shown in the chart below, the U.S. trade weighted dollar has been in forming a six year distribution top. In June 2020 the dollar broke beneath a trend line which been in place since 2011. A major determining factor of the value of the dollar is the difference between U.S. interest rates and those of our major trading partners. In July 2018, the U.S. 2-year treasury yield was at 2.69%, while the yield on the German 2-year was negative -0.59%. This resulted in a spread of 328 basis points favoring the U.S. 2-year treasury. In our opinion, this spread advantage was a major factor contributing to U.S. dollar strength. Since mid-2018 the U.S. interest rate advantage over Germany has narrowed significantly. Currently the U.S. 2-year yield is at 0.16% with the German 2-year yielding negative -0.73%. The spread has narrowed to 0.89%. While still favoring the dollar, the cost of hedging must be considered, which would then favor the 2-year German yield. A stronger euro would also benefit investing in German short-term securities.

With the U.S. federal debt level exceeding 100% of GDP, the Fed has a vested interest in keeping interest rates low. The Board of Governors is openly discussing the possibility of having to cap bond yields at the 3-year maturity level. Should the Fed cap yields the pressure on the dollar will increase and only serve to exacerbate inflation momentum.



RISKS

- A gradual decline in the dollar morphs into a rapid one
- Bond yields rise despite the Fed implementing a yield cap
- The level of equity market overvaluation continues with limited earnings growth

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January 2021

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