USC Marshall
School of Business

February 2, 2022

USC Center for Investment Studies.

Students,

Thank you all very much for inviting me into your classroom. It is indeed a pleasure speaking with you today. These are interesting times in the markets as the Federal Reserve is about to conduct a most exciting test of monetary policy, and that is the rare unwind of quantitative easing. And by the end of it, you will forever be able to say, you were there when the great monetary experiment ended.

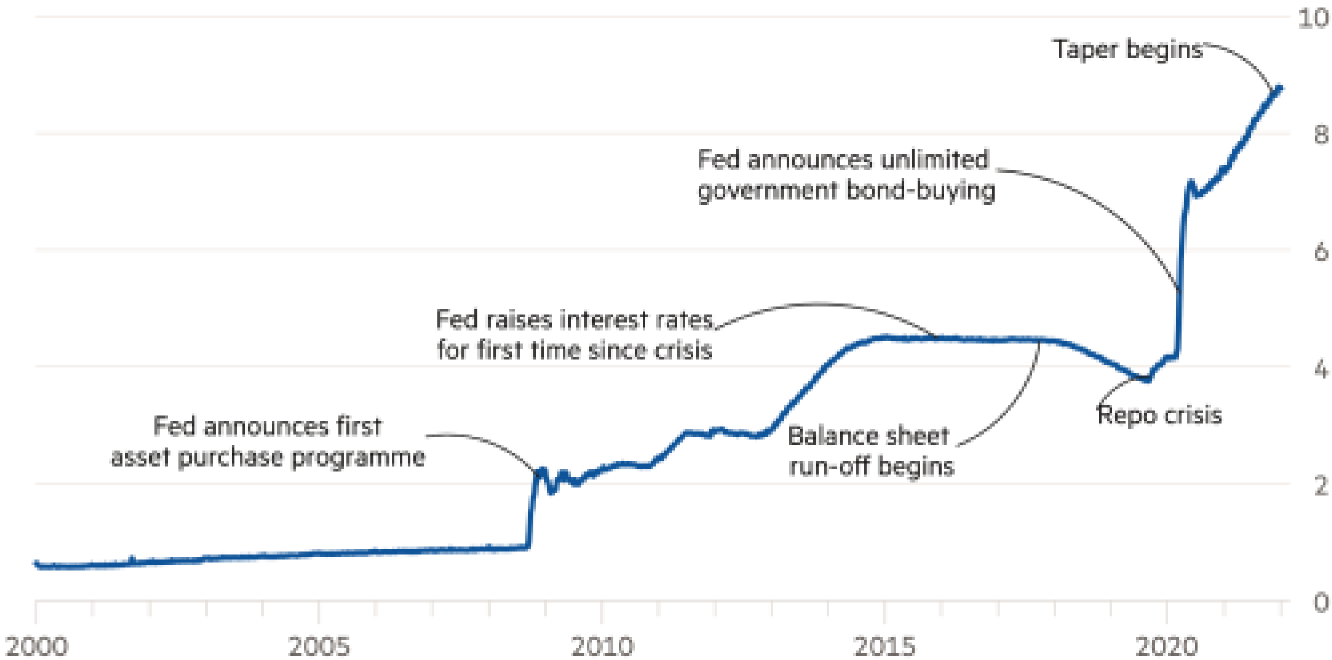
Fight Onward!

Bryan

As you can see below, at least one generation of Wall Streeter has never experienced what the removal of QE looks like. And those that came before probably don’t remember what it looks like. Not the easiest chart to see, but it works.

Fed's balance sheet plans have markets on edge

Assets held by the Federal Reserve ($tn)



Sources: Federal Reserve, Bloomberg

Today's discussion could therefore be incredibly timely, as markets have recently been in flux and we are finally seeing the impact of an ultra-loose policy. And that impact is inflation. A monster that was once so feared but has in recent years been thought of as extinct. This cover of Bloomberg's weekly is from April of 2019.

Bloomberg Businessweek
April 22, 2019

Is Inflation Dead?

A new era has some frightening downsides

With that as backdrop, let's get down to today's subject material as suggested by your instructors:

- Inflation, direction of interest rates, Fed policy and the implication for markets

- Value stocks vs. growth stocks in the current environment with inflation and valuation concerns

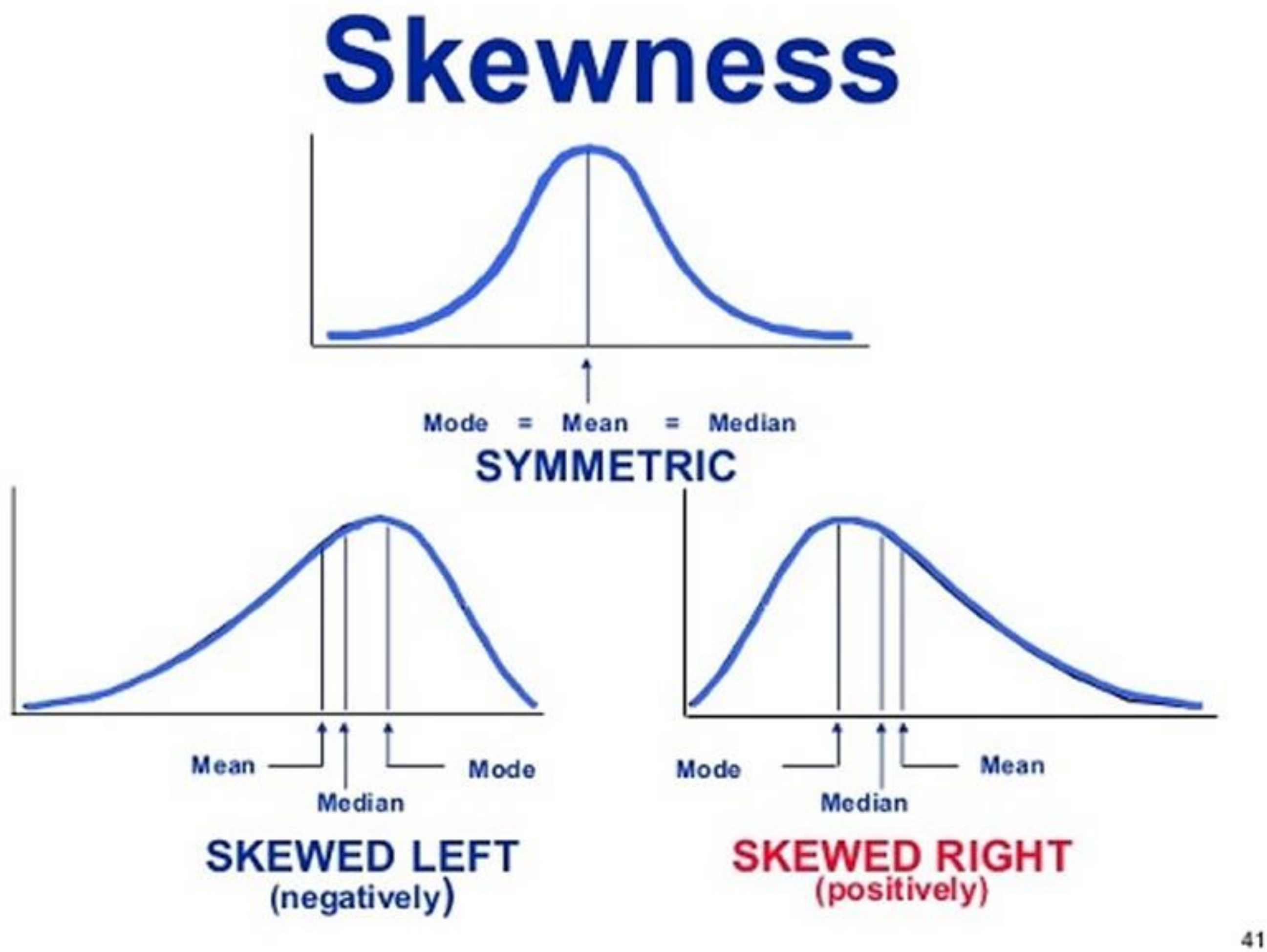
- Potential direction of the US dollar and the impact for currency risk in overseas investments (e.g., emerging market equities)

- Is now a time to draw down risk and keep some dry powder?

- Individual stock picks or interesting story stocks – whatever you might be enthusiastic about.

All great topics, especially as I mentioned during a time of transition for markets, one where investment committees are going to be forced to make decisions about tacking the boat or remaining full steam ahead. Like a speed boat, investment environments can turn on a dime, but investment policies and positioning move more like aircraft carriers. Still very impressive though.

Before we get started, let me give you my background in the business, where I started, what I traveled through, and where I am today. It's been a twenty-six year, half of my lifetime, experience that has had a bell curves worth of ups and downs, and even some time in the middle.



Bryan Goligoski Bio

UCLA undergraduate degree in 1995. Major in Political Science, with an emphasis in Business Administration and the coursework equivalent of an accounting minor. I thought I wanted to be a lawyer until I spent a summer in Washington D.C. and re-directed my trajectory to finance and accounting. Walked my graduation in Pauley Pavilion with George Zidek, Tyus Edney, and Ed O'Bannon. The three seniors on the last Ucla hoops team to win a National Championship, try as we Bruins might.

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Hired by head of equities, Malcom Fairbairn, as an analyst at Mark Strom's global macro hedge fund in Santa Monica. After doubling client's money twice the early 1990's, Mark would be included in the same sentences with Julian Robertson and George Soros. I was an equity generalist, short selling specialist, and managed a portion of the portfolio at the age of 26. It was an intoxicating environment for someone new to the business.

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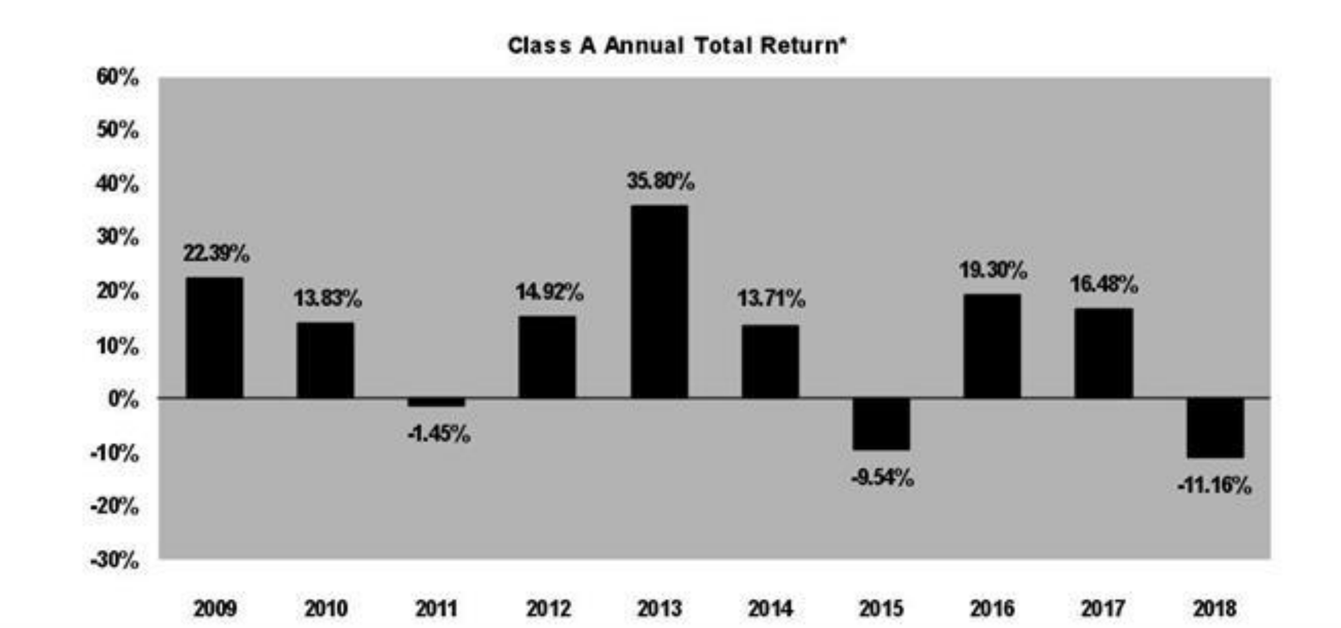
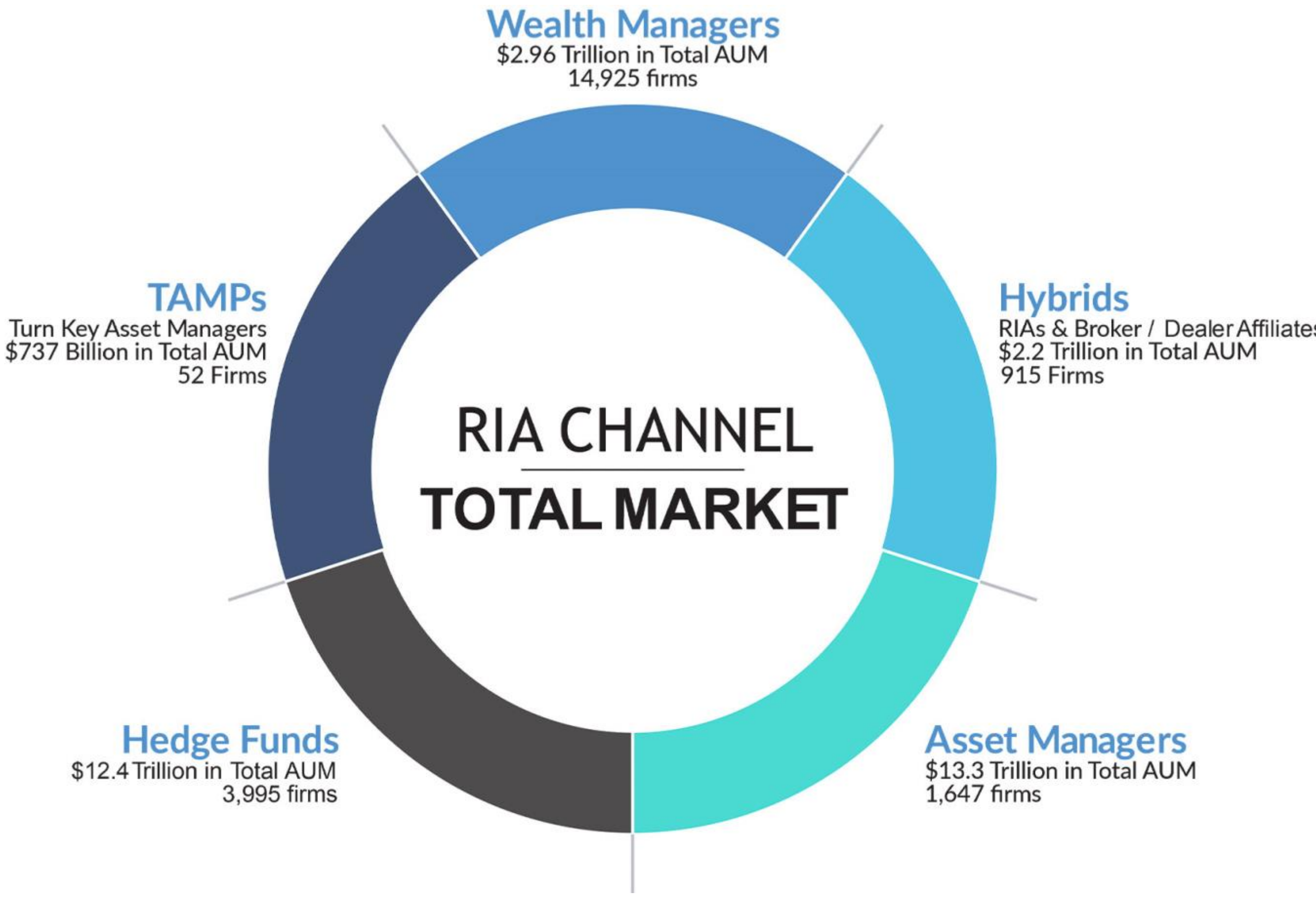
Next professional train stop would be Santa Barbara Asset Management in 2004, a $5 billion growth focused asset manager out of, you guessed it, Santa Barbara. Main body of work was a 50-stock portfolio of companies we deemed to have ‘stable growth’ characteristics. The firm was acquired by Nuveen in 2005 for $150 million, with $75 up front and $75 on the back end if milestones were met. My personal claim to fame was the founding of the Nuveen Equity Long/Short mutual fund (Symbol: NELAX) in January 2009 and managed the fund through December 2012.

- 

After eight years at Nuveen I moved on to several short stints, all within finance. There was business development for Mercer Advisors, a $5 billion at the time, RIA consolidator. In your career, do not overlook the ‘pedestrian’ yet stable world of wealth management and financial planning. At age 50, your spouse will thank you.



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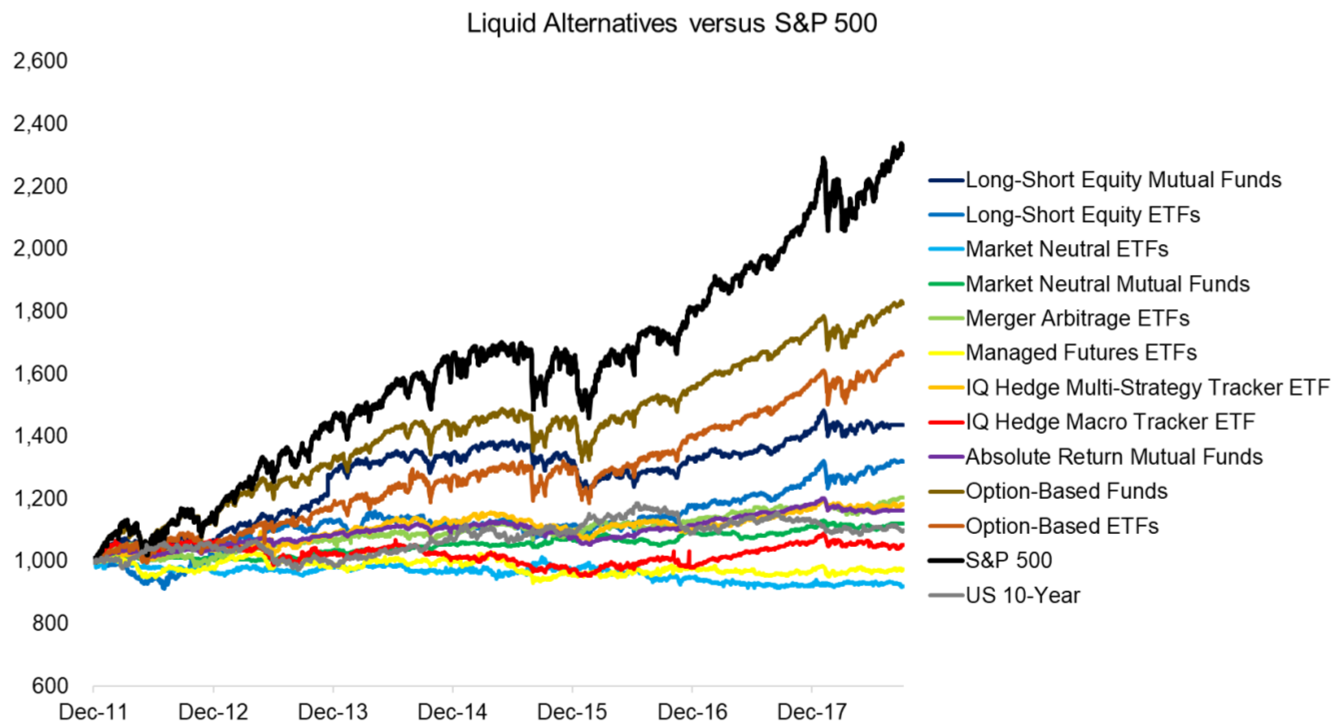
Two (very) short stints after that. One with Hatteras Funds, a fund-of-funds in a mutual fund wrapper where I was a product specialist. And TCW (Trust Company of the West) where I once again wore the hat of alternative specialist. Hatteras died from lack of interest in expensive fund-of-funds, TCW because of lack of balance sheet to follow through on the dream of relevance in liquid alternatives. But was it really a dream?

* 

One of the highlights of my brief tenue at TCW was getting to work with Milken alum, Jess Ravich, and reporting to fund board chairman and former USC Athletic Director, Pat Haden. Pat graduated from SC magna cum laude, Phi Beta Kappa, has a law degree from Loyola, and is also a Rhodes Scholar. While intimidating to report to, Haden could not have been nicer, and is emblematic of the kind of people you get to meet in this business.

Final stop, and where I currently reside, Stillwater Capital LLC, a catch all for any opportunities that come my way in finance: asset management, trading, financial journalism, wealth advisement, and anything else that comes my way. California based LLC (a whopping $800 annually) with a blank canvass to work with

But enough about me, on to the subjects at hand, for these are indeed changing times, with broad implications for asset class performance and returns going forward. Get to know this chart, the asset class return quilt, it will be with you forever if you are in the business of investments.

Asset Class Returns

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total
EM 39.8%	HG Bnd 5.2%	EM 79.0%	REIT 28.0%	REIT 8.3%	REIT 19.7%	Sm Cap 38.8%	REIT 28.0%	REIT 2.8%	Sm Cap 21.3%	EM 37.8%	Cash 1.8%	Lg Cap 31.5%	Sm Cap 20.0%	REIT 41.3%	Lg Cap 356.8%
Int'l Stk 11.6%	Cash 1.7%	HY Bnd 57.5%	Sm Cap 26.9%	HG Bnd 7.8%	EM 18.6%	Lg Cap 32.4%	Lg Cap 13.7%	Lg Cap 1.4%	HY Bnd 17.5%	Int'l 25.6%	HG Bnd 0.0%	REIT 28.7%	EM 18.7%	Lg Cap 28.7%	Sm Cap 249.1%
AA 7.6%	AA -22.4%	Int'l Stk 32.5%	EM 19.2%	HY Bnd 4.4%	Int'l Stk 17.9%	Int'l Stk 23.3%	AA 6.9%	HG Bnd 0.6%	Lg Cap 12.0%	Lg Cap 21.8%	HY Bnd -2.3%	Sm Cap 25.5%	Lg Cap 18.4%	Sm Cap 14.8%	REIT 194.8%
HG Bnd 7.0%	HY Bnd -26.4%	REIT 28.0%	HY Bnd 15.2%	Lg Cap 2.1%	Sm Cap 16.4%	AA 11.5%	HG Bnd 6.0%	Cash 0.0%	EM 11.6%	Sm Cap 14.7%	REIT -4.0%	Int'l Stk 22.7%	AA 9.8%	Int'l Stk 11.8%	HY Bnd 173.1%
Lg Cap 5.5%	Sm Cap -33.8%	Sm Cap 27.2%	Lg Cap 15.1%	AA 0.3%	Lg Cap 16.0%	HY Bnd 7.4%	Sm Cap 4.9%	Int'l Stk -0.4%	REIT 8.6%	AA 14.6%	Lg Cap -4.4%	AA 18.9%	Int'l Stk 8.3%	AA 10.9%	AA 153.4%
Cash 4.4%	Lg Cap -37.0%	Lg Cap 26.5%	AA 13.5%	Cash 0.1%	HY Bnd 15.6%	REIT 2.9%	HY Bnd 2.5%	AA -1.3%	AA 7.2%	REIT 8.7%	AA -5.6%	EM 18.9%	HY Bnd 7.5%	HY Bnd 5.4%	EM 102.1%
HY Bnd 2.2%	REIT -37.7%	AA 24.6%	Int'l Stk 8.2%	Sm Cap -4.2%	AA 12.2%	Cash 0.1%	Cash 0.0%	Sm Cap -4.4%	HG Bnd 2.7%	HY Bnd 7.5%	Sm Cap -11.0%	HY Bnd 14.4%	HG Bnd 6.1%	Cash 0.0%	Int'l Stk 82.4%
Sm Cap -1.6%	Int'l Stk -43.1%	HG Bnd 5.9%	HG Bnd 6.5%	Int'l Stk -11.7%	HG Bnd 4.2%	HG Bnd -2.0%	EM -1.8%	HY Bnd -4.6%	Int'l Stk 1.5%	HG Bnd 3.5%	Int'l Stk -13.4%	HG Bnd 8.7%	Cash 0.6%	HG Bnd -1.5%	HG Bnd 82.4%
REIT -15.7%	EM -53.2%	Cash 0.1%	Cash 0.1%	EM -18.2%	Cash 0.1%	EM -2.3%	Int'l Stk -4.5%	EM -14.6%	Cash 0.3%	Cash 0.8%	EM -14.3%	Cash 2.2%	REIT -5.1%	EM -2.2%	Cash 12.9%

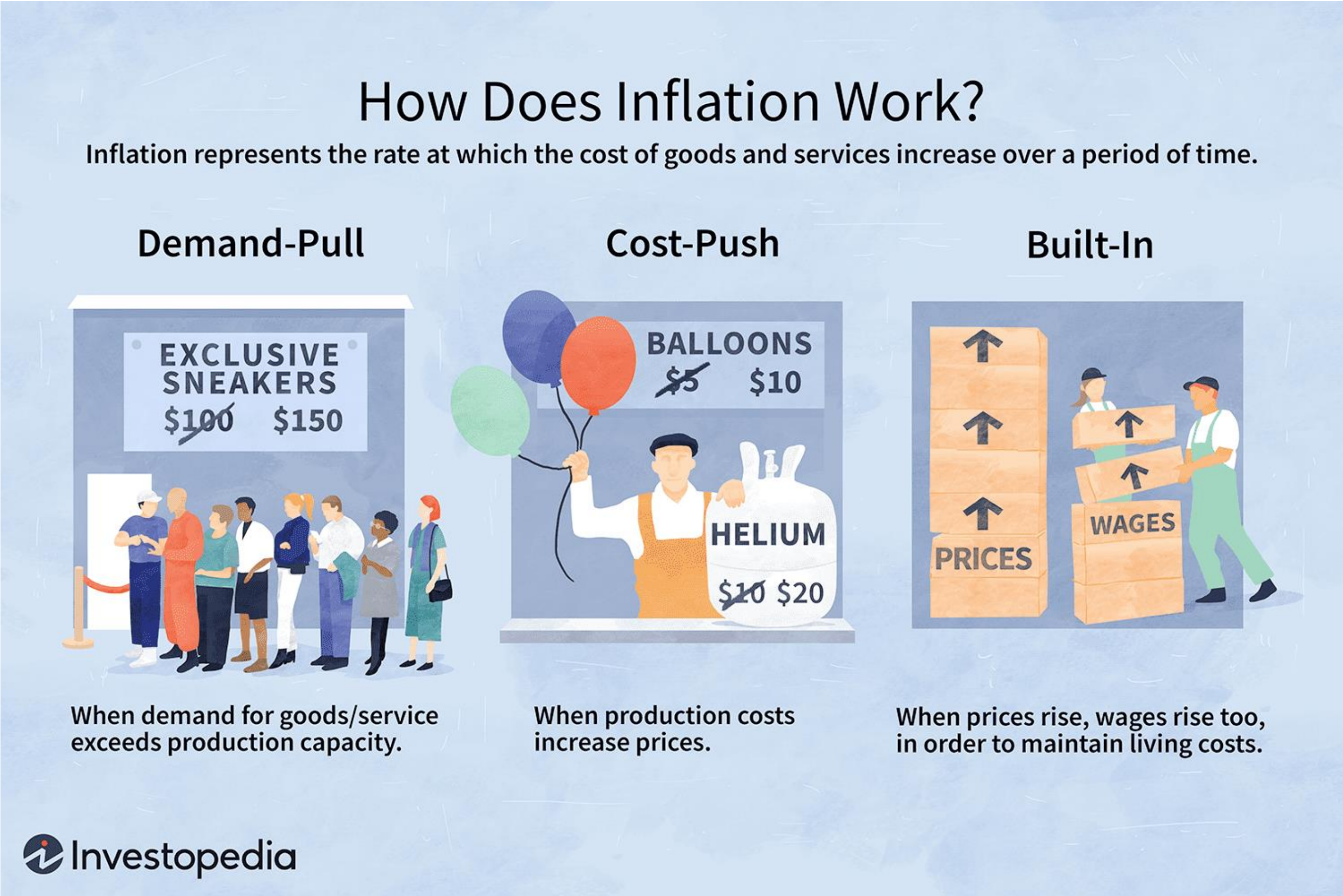
Abbr.	Asset Class – Index	Annual	Best	Worst
Lg Cap	Large Cap Stocks – S&P 500 Index	10.66%	32.4%	-37.0%
Sm Cap	Small Cap Stocks – Russell 2000 Index	8.69%	38.8%	-33.8%
Int'l Stk	International Developed Stocks – MSCI EAFE Index	4.09%	32.5%	-43.1%
EM	EM Stocks – MSCI Emerging Markets Index	4.80%	79.0%	-53.2%
REIT	REITs – FTSE NAREIT All Equity Index	7.47%	41.3%	-37.7%
HG Bnd	High Grade Bonds – Bloomberg Barclays U.S. Agg Index	3.99%	8.7%	-2.0%
HY Bnd	High Yield Bonds – ICE BofA US High Yield Index	7.02%	57.5%	-26.4%
Cash	Cash – S&P U.S. Treasury Bill 0-3 Mth Index	0.81%	4.4%	0.0%
AA	Asset Allocation Portfolio*	6.66%	24.6%	-22.4%

Past performance does not guarantee future returns. The historical performance shows changes in market trends across several asset classes over the past fifteen years. Returns represent total annual returns (reinvestment of all distributions) and does not include fees and expenses. The investments you choose should reflect your financial goals and risk tolerance. For assistance, talk to a financial professional. All data are as of 12/31/21.
*Asset Allocation Portfolio is 15% large cap stocks, 15% international stocks, 10% small cap stocks, 10% emerging market stocks, 10% REITs, 40% high-grade bonds, and annual rebalancing.

Onward…

Inflation, direction of interest rates, Fed policy and the implication for markets.

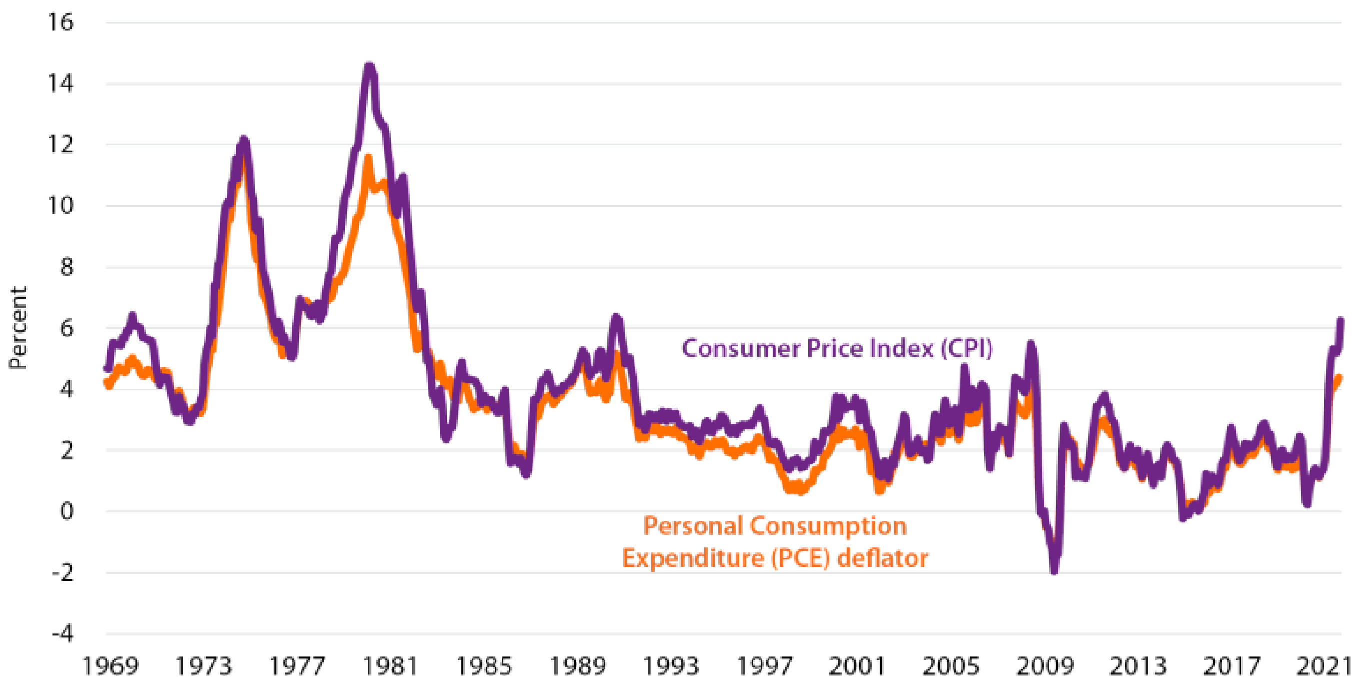
Let's start off with what the markets are focused on most: Inflation. It is here. It is ubiquitous. It is not transitory. And it will be costing Joe Biden his second term. While pedestrian, the description below accurately represents what is currently driving prices higher at a rate not seen in at least two generations.



This chart goes all the way back to 1969 and shows how volatile it once was, how calm it had become, and how the recent spike off lows has the markets turning upside down, and with them asset classes that have gone from first to worst, and vice versa.

FIGURE 1.

One-year Inflation, PCE and CPI Measures, 1969–2021

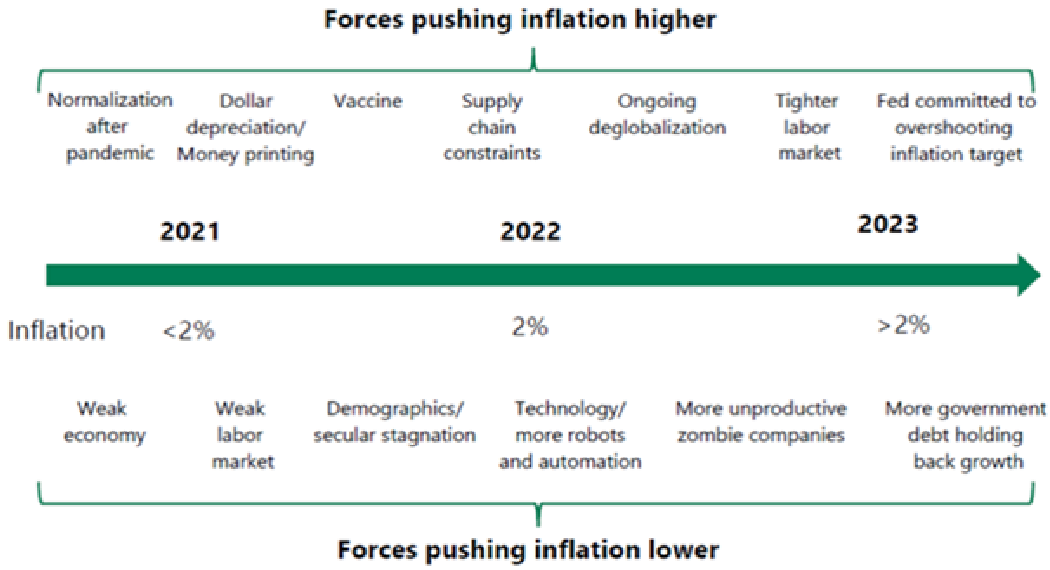


Source: US Census Bureau; US Bureau of Economic Analysis; author's calculation.

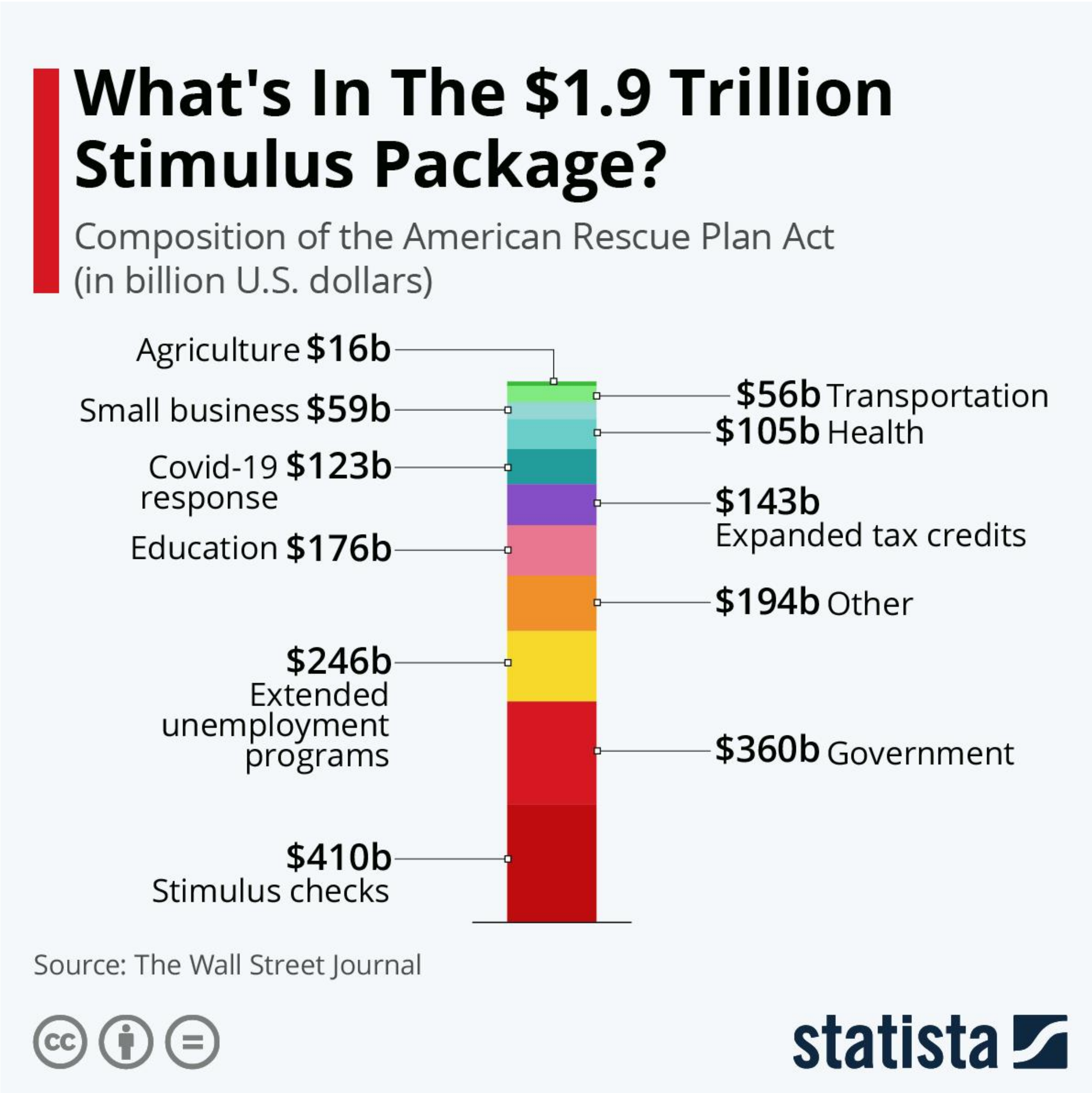
THE HAMILTON PROJECT
BROOKINGS

So, what are the real time causes of inflation today? Number one, and it’s getting flogged heavily right now, the disruption of supply chains and the challenge in restarting a global economy. Tightness across inputs like semiconductors, lumber, metals, base products for food production, etc. are all seeing demand pull without adequate resources and capacity utilization to meet it.

Inflation outlook: Near-term low, medium term higher

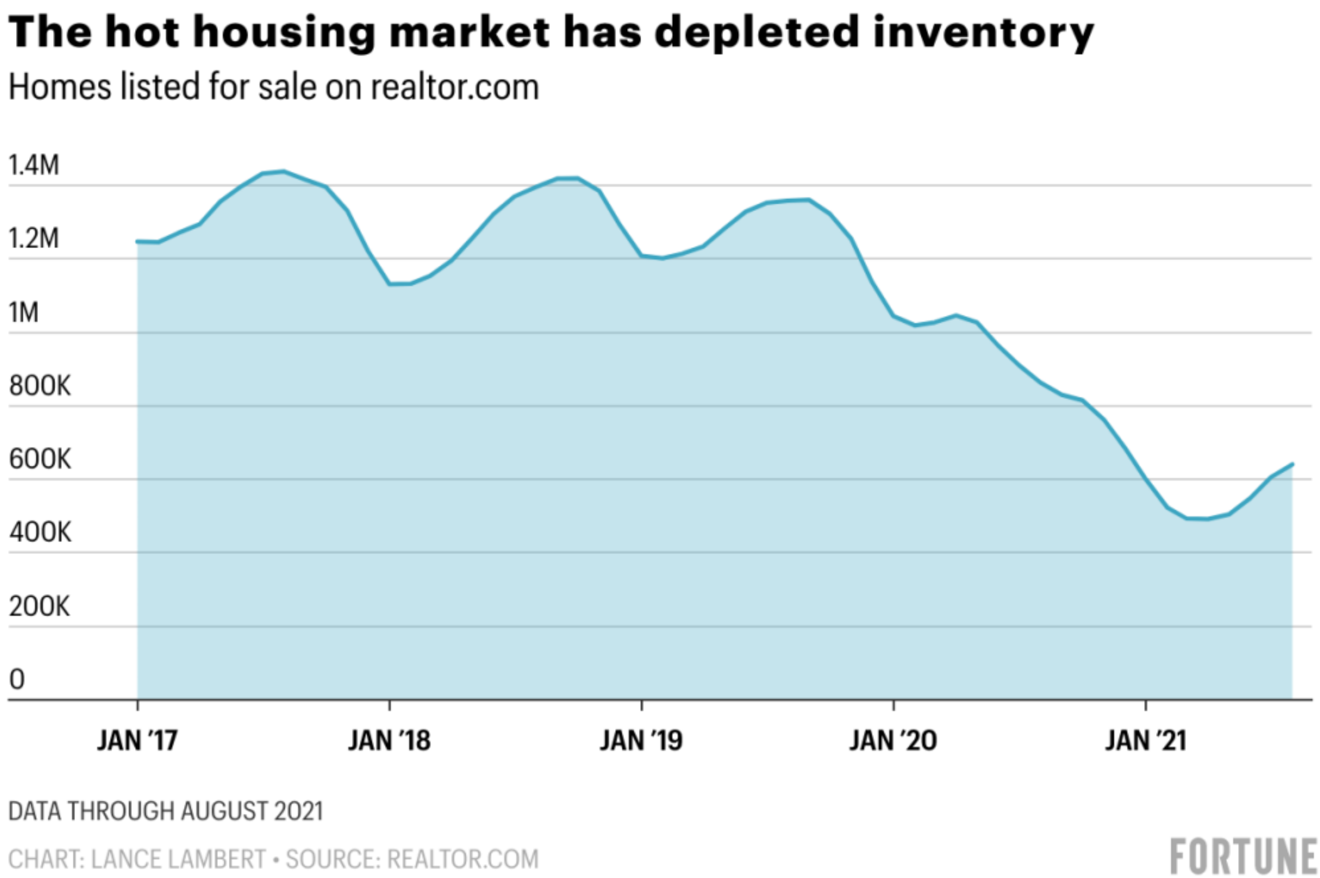


On the demand side, we have seen stimulus a-go-go, and that has put plenty of cash in the consumers hands and the pandemic really hasn't slowed down the want for goods. These are simply not small numbers. I'm personally getting checks in the mail for things I didn't even know I qualified for.

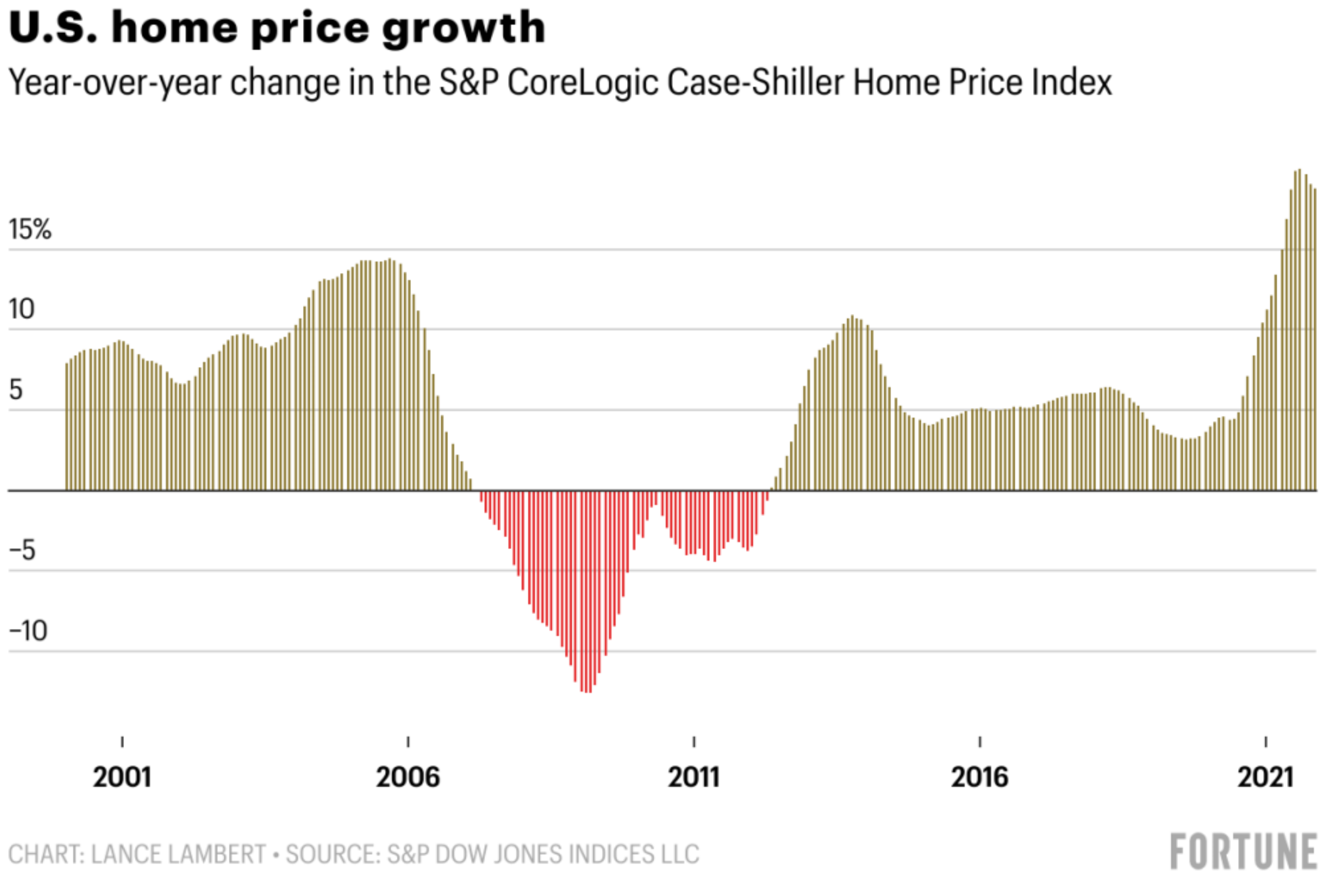


Not only is there a massive flow of fiscal relief, but there is also the Federal Reserve with its monetary pistols with endless amounts of ammunition, or so we thought.

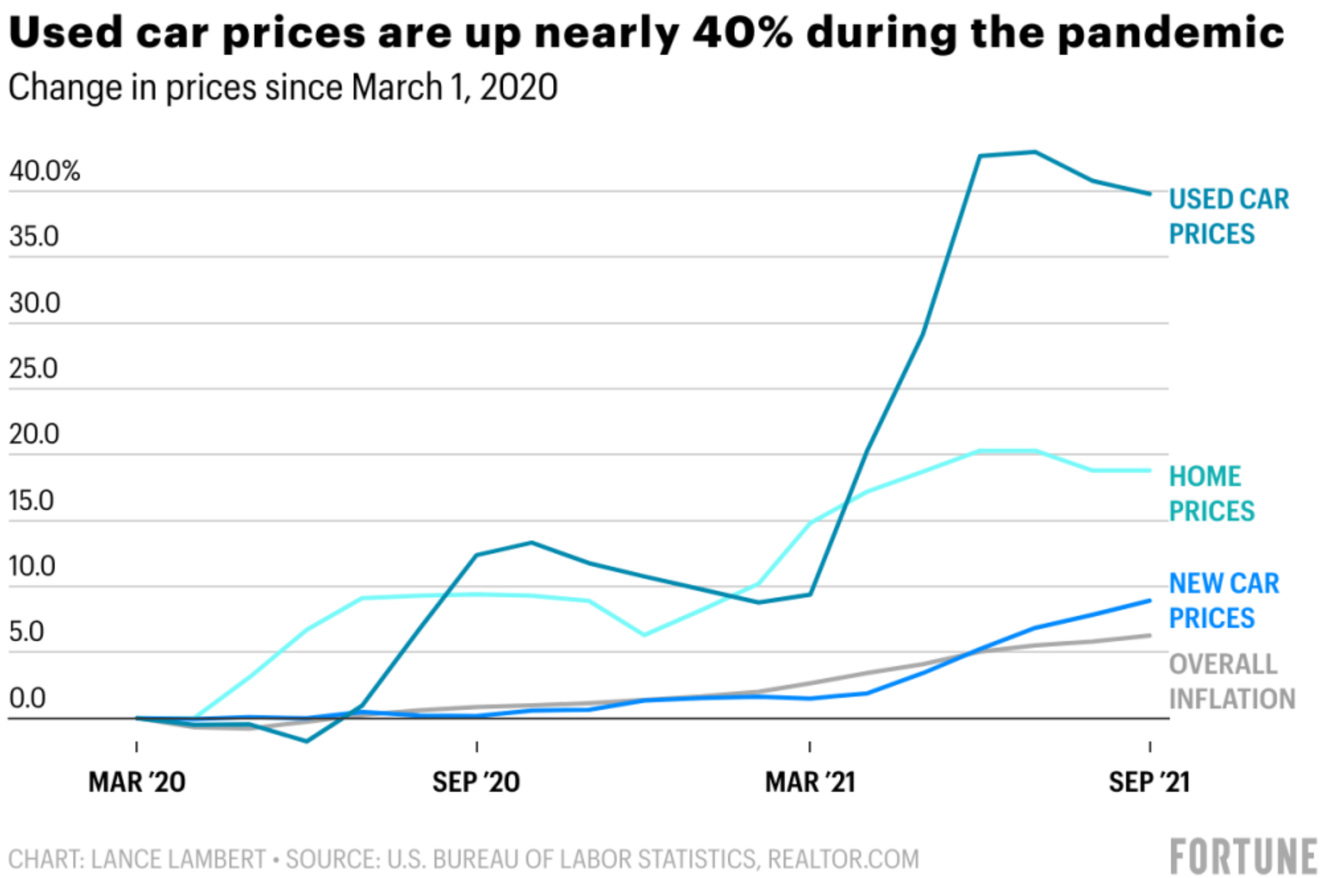
But free money has inflationary consequences. Namely asset price inflation, which if you were on the right side of that equation, have seen a material change in your station in life. During the pandemic, available inventory of homes for sale dropped from 1.3 million, to a low of about 500,000. While this chart dates to August of last year, you get the (frightening) picture.



And when inventory is this tight, and money is that cheap, what happens? Something that few economists thought could happen. A complete and utter blowoff in prices. Did I mention complete and utter blowoff? Because that's what this is. And when you are in a bank approved levered trade, that is a seriously massive, annualized return.



Where else are we seeing inflation? In the used car market, for one. Simply too much demand, and not enough inventory of both new and used cars. And this impacts everyone. From the coasts to the flyover states.



Again, to emphasize, this impacts everyone. Not just those who are asset rich in California, New York, and Florida. The flyovers are getting pinched hard right now. Very hard.

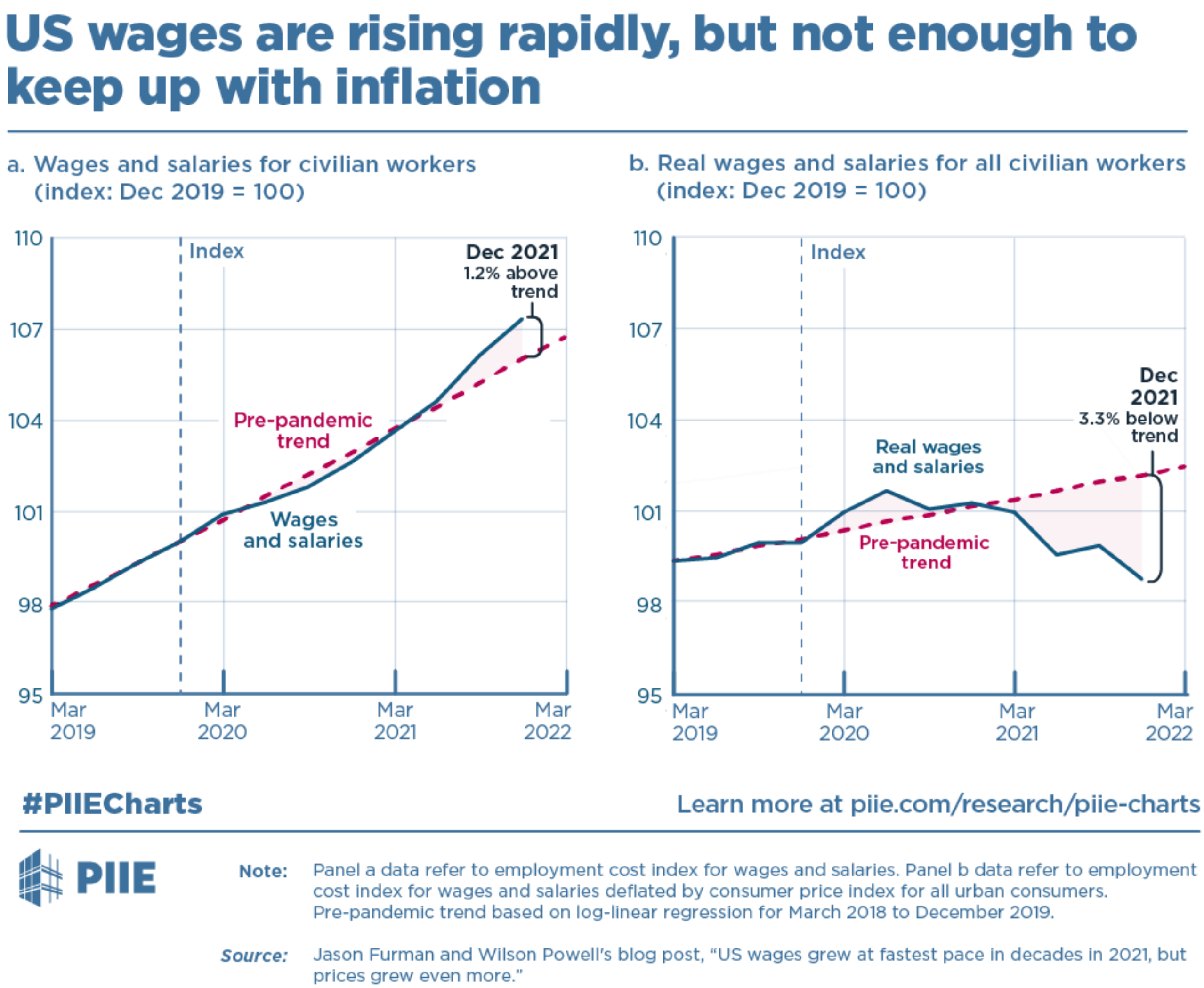
Grocery prices are soaring

Putting dinner on the table has gotten a lot more expensive

	Oct 2020	Oct 2021	% change
Eggs (dozen)	$1.41	$1.82	29.3%
Beef chuck roast (1 lb)	$5.75	$7.40	28.7%
Bacon (1 lb)	$5.72	$7.32	27.9%
Ground beef (1 lb)	$4.00	$4.72	17.7%
Pork chops (1 lb)	$3.63	$4.15	14.2%
Sugar (1 lb)	$0.63	$0.71	12.5%
Boneless chicken breast (1 lb)	$3.29	$3.59	9.1%
Milk (gallon)	$3.38	$3.66	8.4%
Coffee (1 lb)	$4.52	$4.80	6.1%

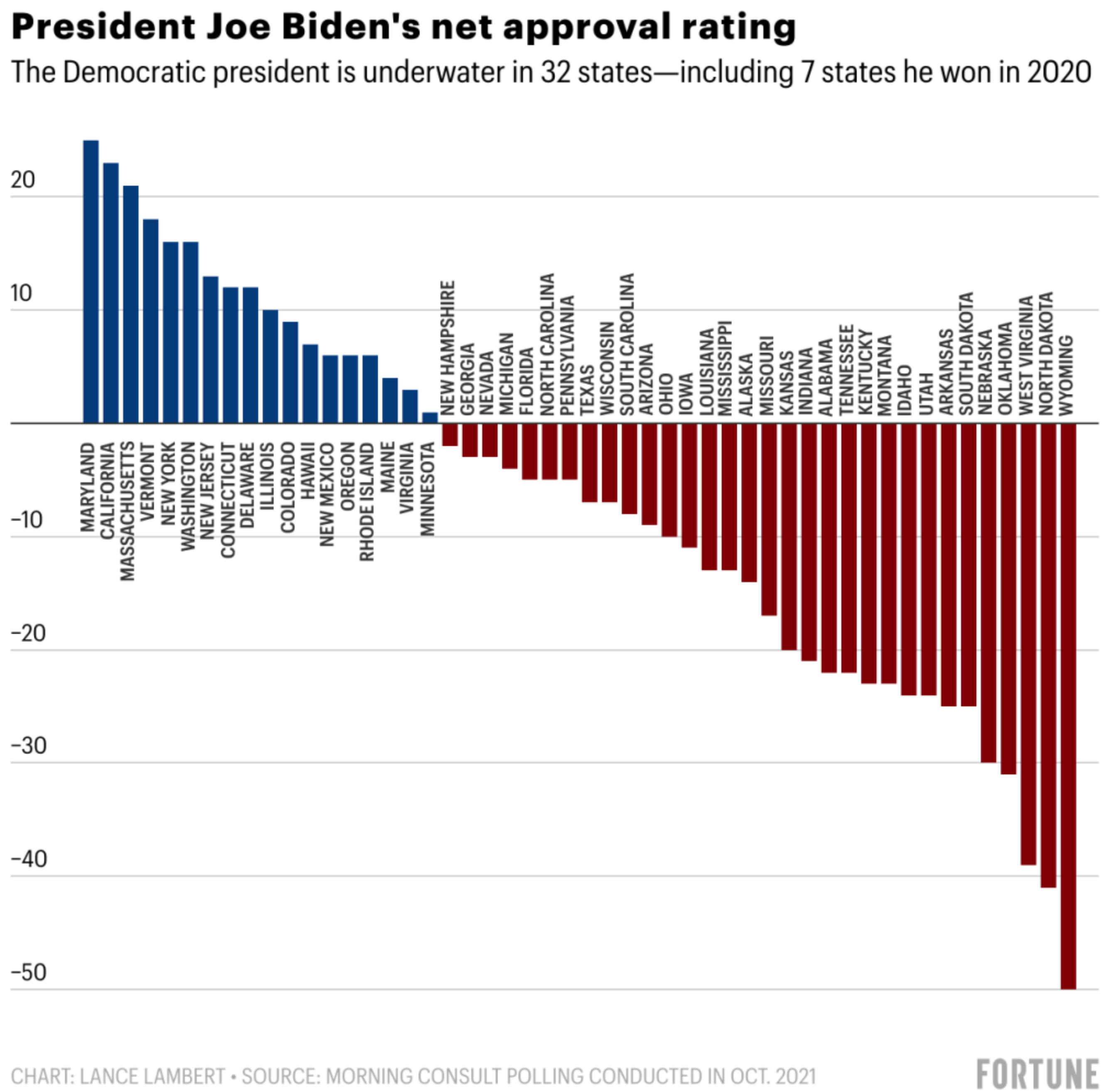
Source: Bureau of Labor Statistics

Good news though, wage inflation has picked up, but not enough to offset the spike in goods.



What does this mean for President Biden? Looks like he will be one and done, and that's okay. He did his job but will also go down as looking like he was asleep at the wheel for the common man.

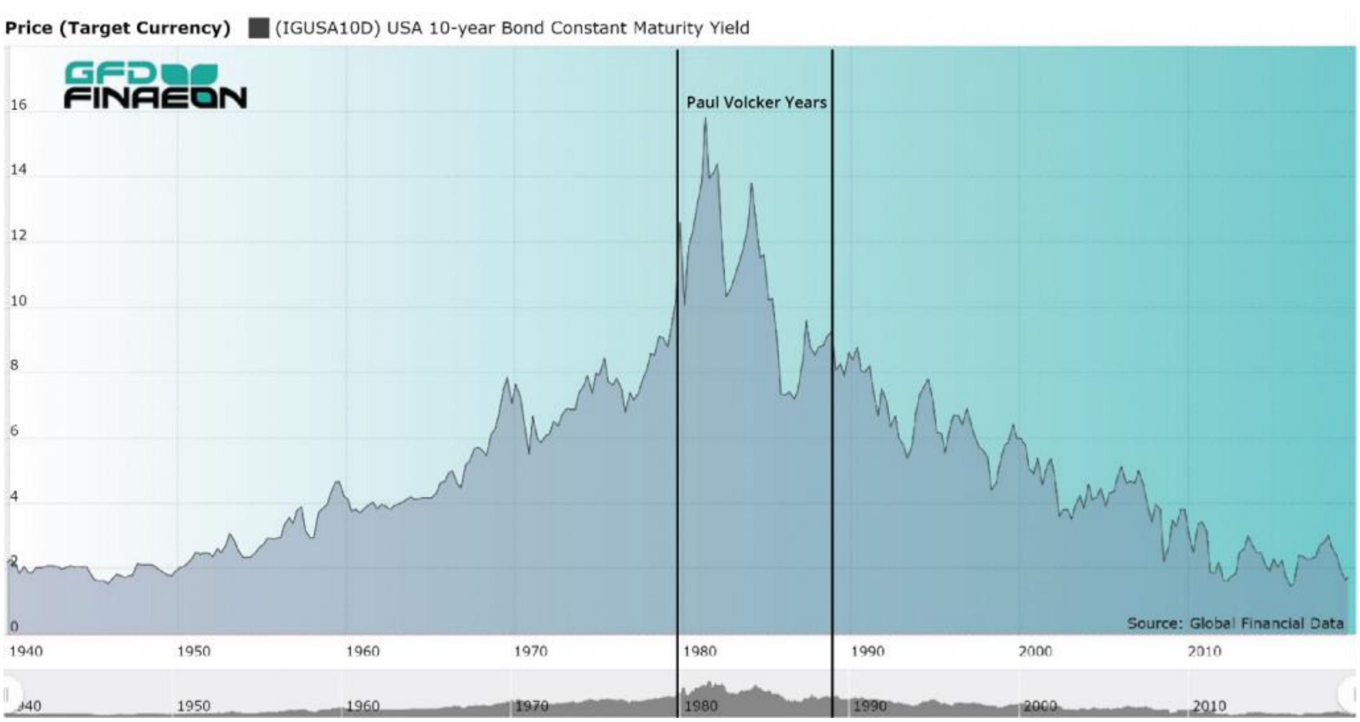
Once again, the Democrats own the coasts but are losing favor among Joe and Joelle six pack.



Sidebar: If you are into music and want to get a whole new view of the president that went out with a whimper, watch the documentary *Jimmy Carter, Rock & Roll President.* It will change the way you look at the 39th man to call the Oval Office the place he does business.

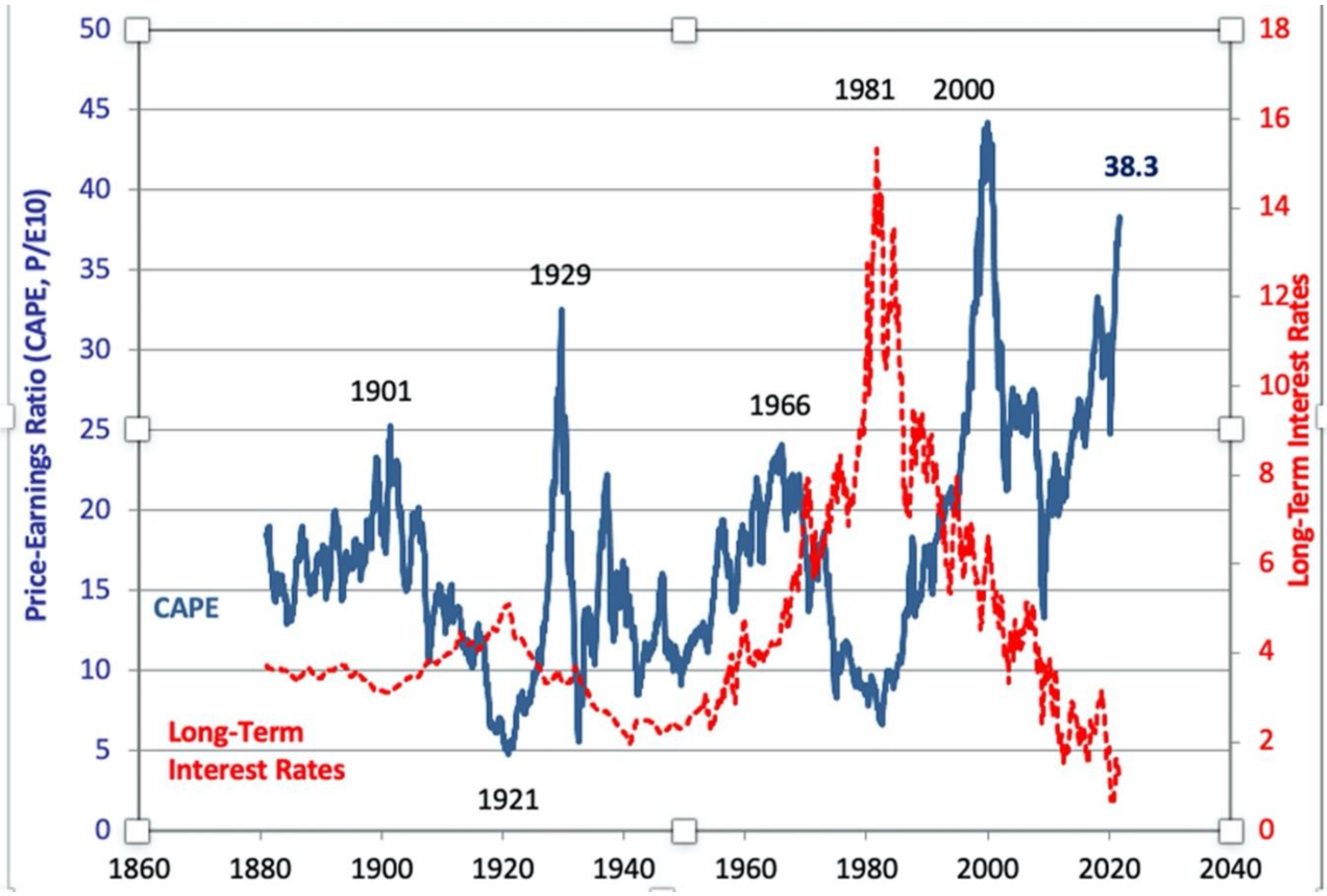
So, who was the last man to slay inflation, Paul Volker when he took the helm of the Federal Reserve in 1979. While we don't use the phrase 'stud' in economics much, this tall glass of water was one. Firing up a heater of size and consequence during a congressional hearing says it all.

What he did to inflation by jacking the Federal Funds rate to something near 20% is beyond conceivable today. Current consensus is for a tightening program that takes us to 2.5%! This chart is of what the 10-year was then and is enow.

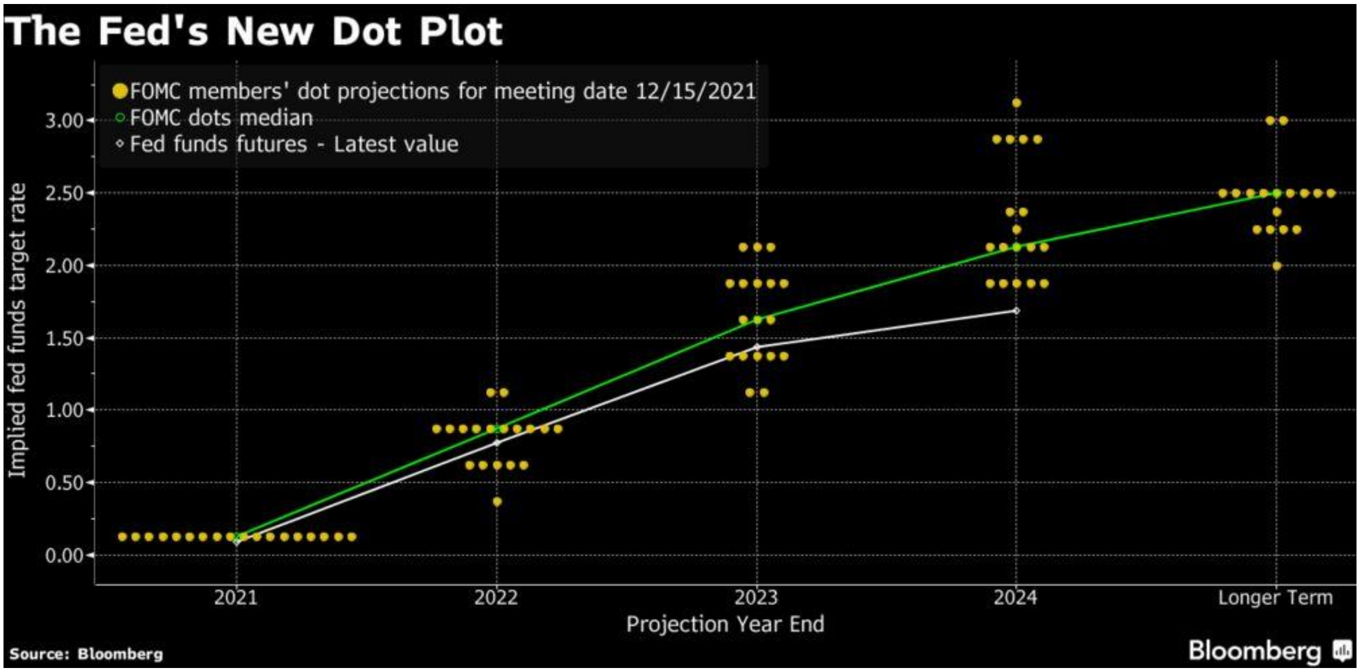


And with lower rates, the greatest bull market in history started to take off.

And with rates on the decline, valuations had the ability to settle out at higher historical levels.



Where are we today? High relative valuation with interest rates clearly on the rise. This has never been a good thing for equity markets and the case for a period of digestion is compelling.



And here is what Wall Street thinks of what the Fed is capable of in 2022…

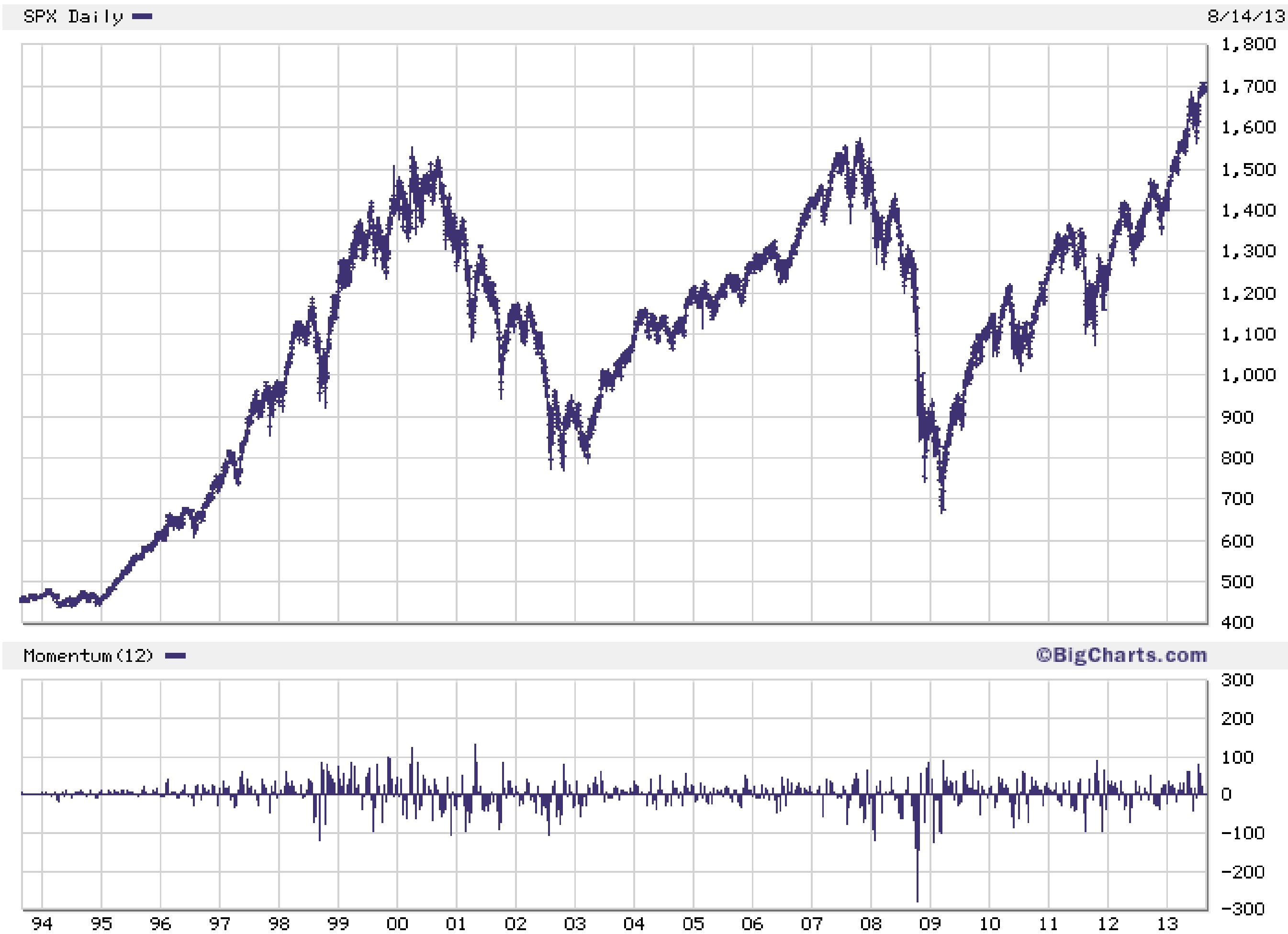
Jonathan Ferro
@FerroTV

2022 Fed hike guesses

MS: 4
DB: 5
GS: 5
Citi: 5
JPM: 5
Wells: 5
BNP: 6
BofA: 7

3:06 AM · Jan 31, 2022 · Twitter for iPhone

From 1997 through 2014 the market went everywhere, but nowhere. Some version of that seems to be reasonable now. Any sort of reversion to the mean, and tampering of equity market returns, would make sense.



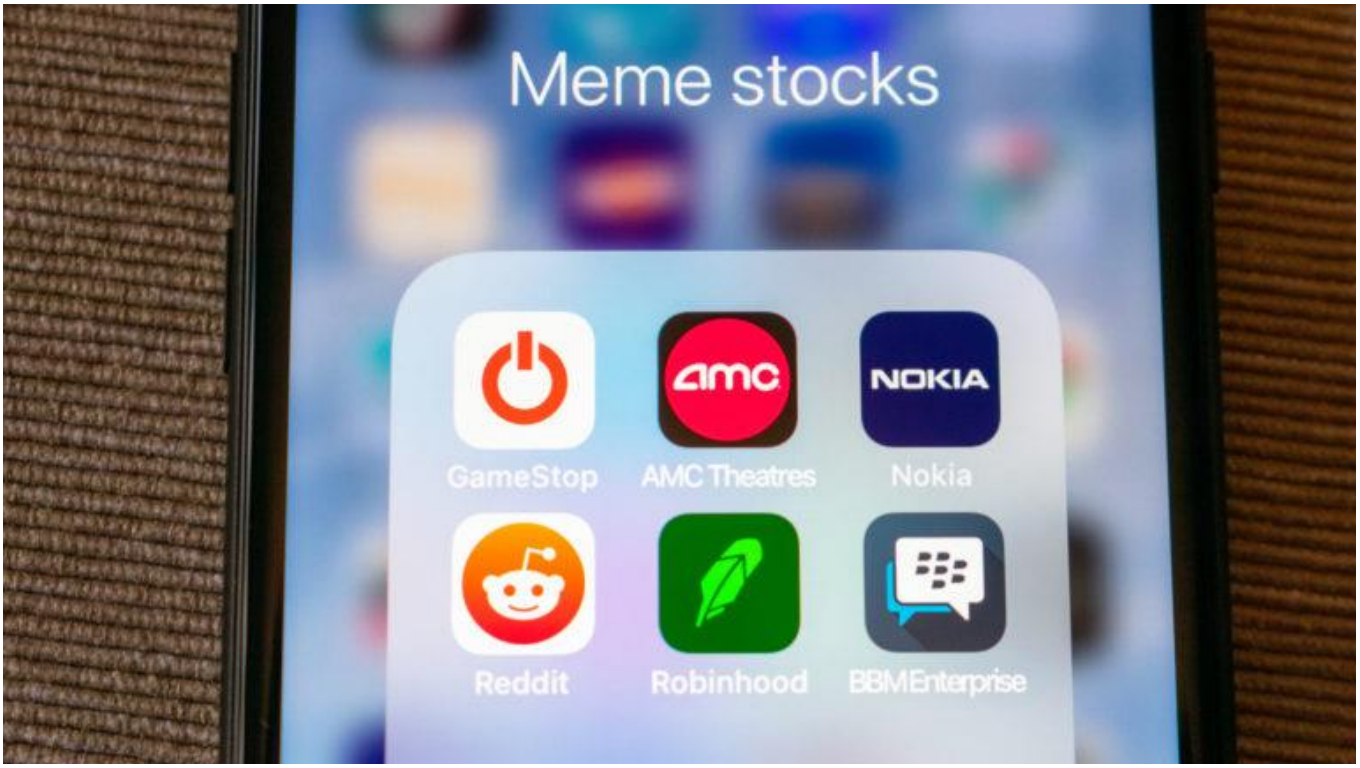
Think interest rates don’t matter to how assets are priced, think again. Or have Warren Buffet do the thinking for you.

"The value of every business, the value of a farm, the value of an apartment, the value of any economic asset is 100% sensitive to interest rates. The higher interest rates are, the less that present value is going to be. Every business, whether it's Coca-Cola or Gillette or Wells Fargo — its intrinsic valuation is 100% sensitive to interest rates."

$$\text{Present Value} = \frac{\text{Cash Flow}}{(1 + i)^{n}}$$

Where:
i = discount rate
n = period number

A lid on equity markets assumes that valuation still matters, and we aren't living in a time of meme stocks and video game investing. Although to us 'old timers', we might as well be.



Let's summarize our first set of topics…

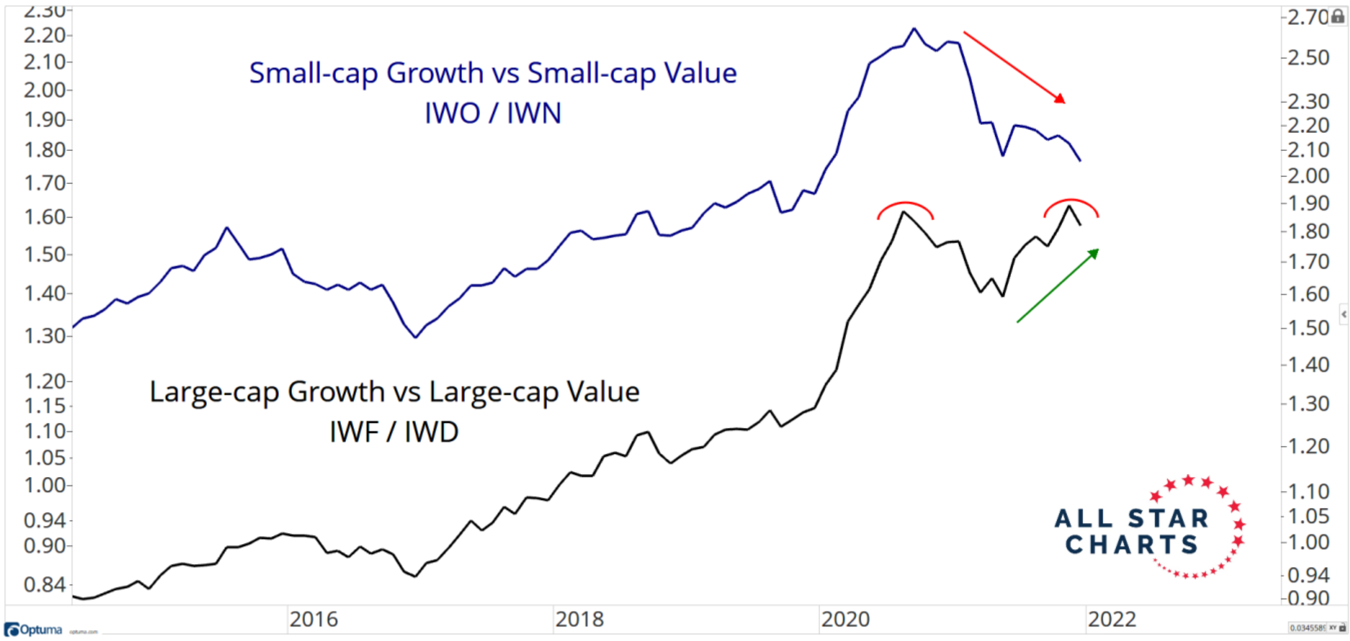
Inflation = It's high and going (somewhat) higher. More importantly, it's sticking around.

Direction of interest rates = They are going up with risk to an overreach.

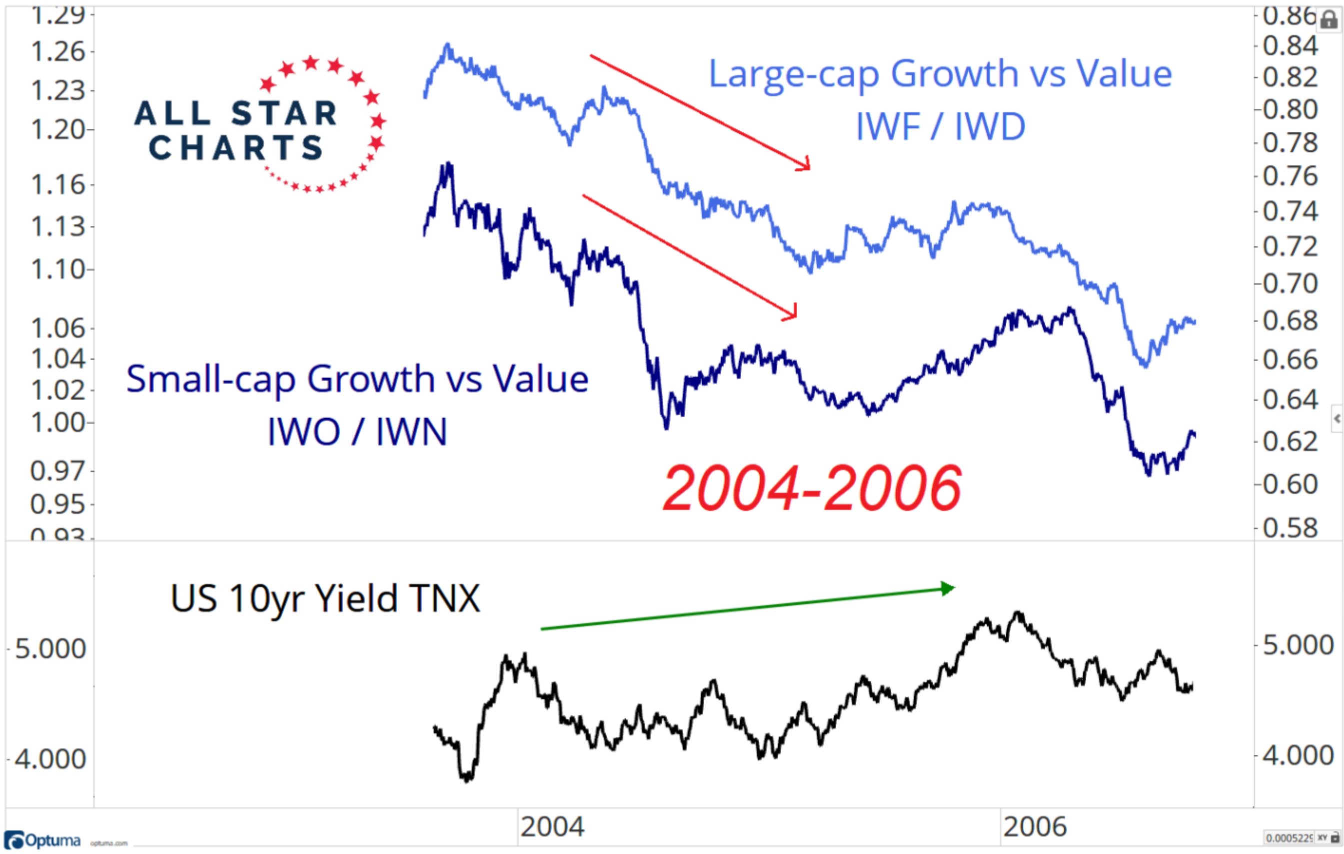
Fed policy = Buckle up, buttercup. It's going to be a bumpy ride.

Implication for Markets = Round one of de-risking has occurred. Look for a sigh of relief, and then another round. There is no such thing as a free lunch, and it's been cheap.

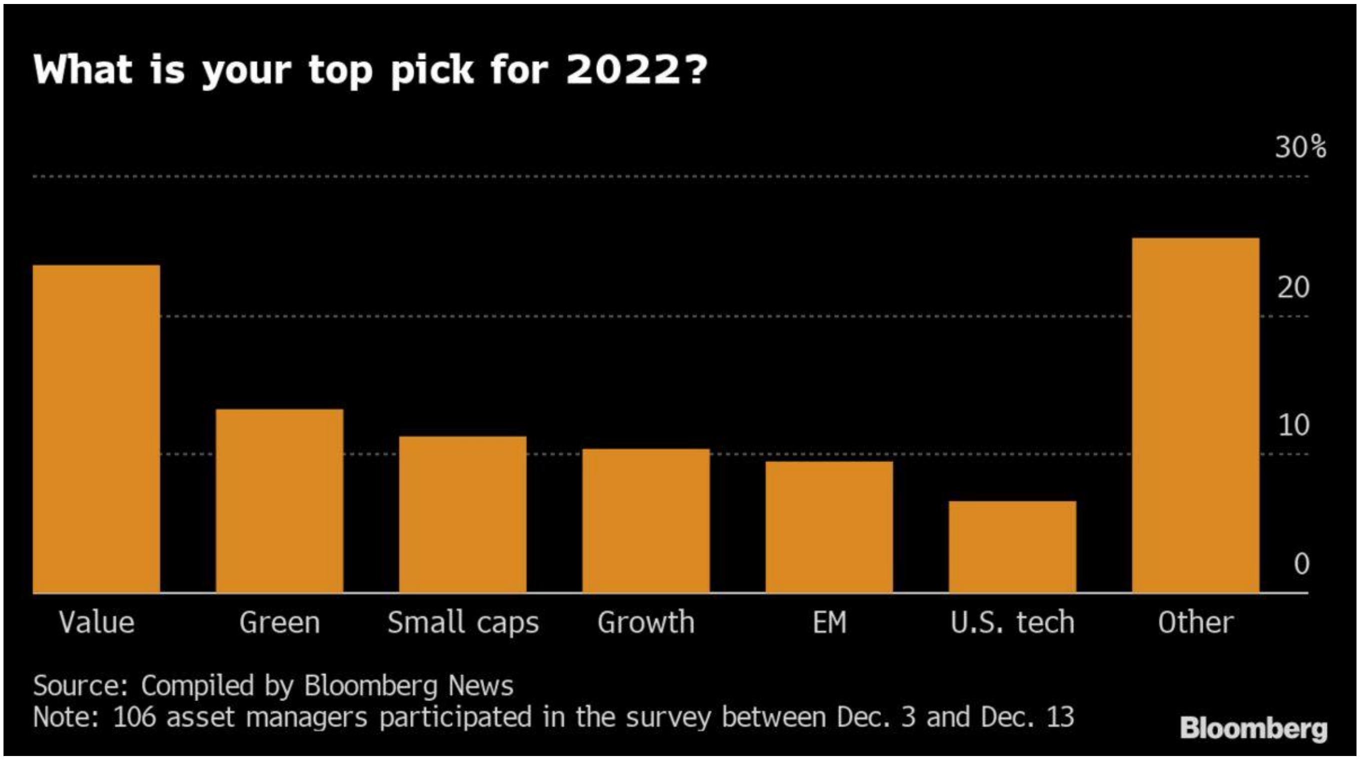
Up next, the well flogged, overly analyzed, long in duration, painful for certain managers, debate about value versus growth equities. Good news for those who have been bored to death by the story about the former is always getting beat by the latter, the trend is starting to change with the prospect of higher interest rates.



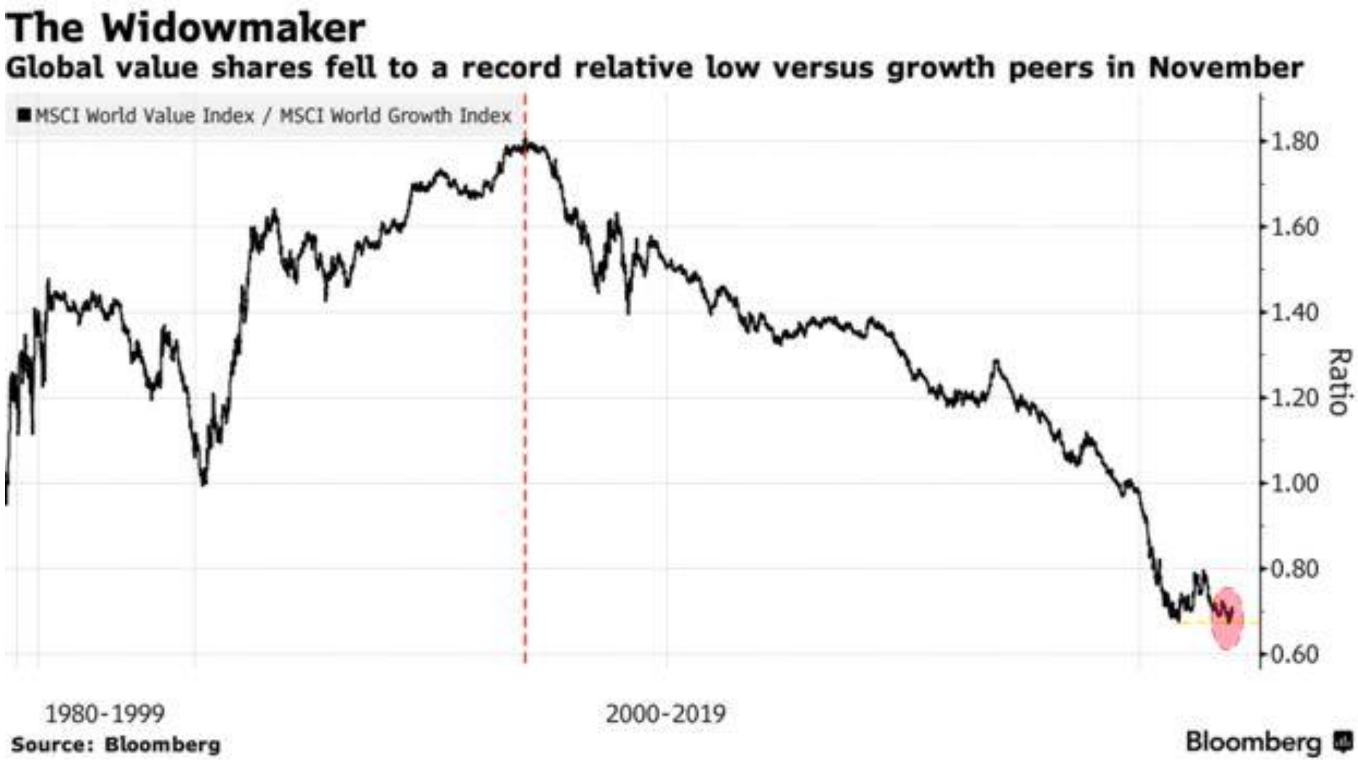
An even more interesting chart from the same source is the one that shows value outperforming growth in the last significant period of rising rates. One of the reasons for this is the heavy component of financial stocks considered to be value. You also have a fat slug of REITs and cyclical stocks from the 'old economy'.



Things perhaps continue to look up for value, as a materially significant 106 asset managers think this will continue to be values year.



It better be, because the opposite trade has been in place for longer than value managers care to remember. I mean, we are talking 20-year trends here. That's rivaling the playoff frustration experienced by the Dallas Cowboys.

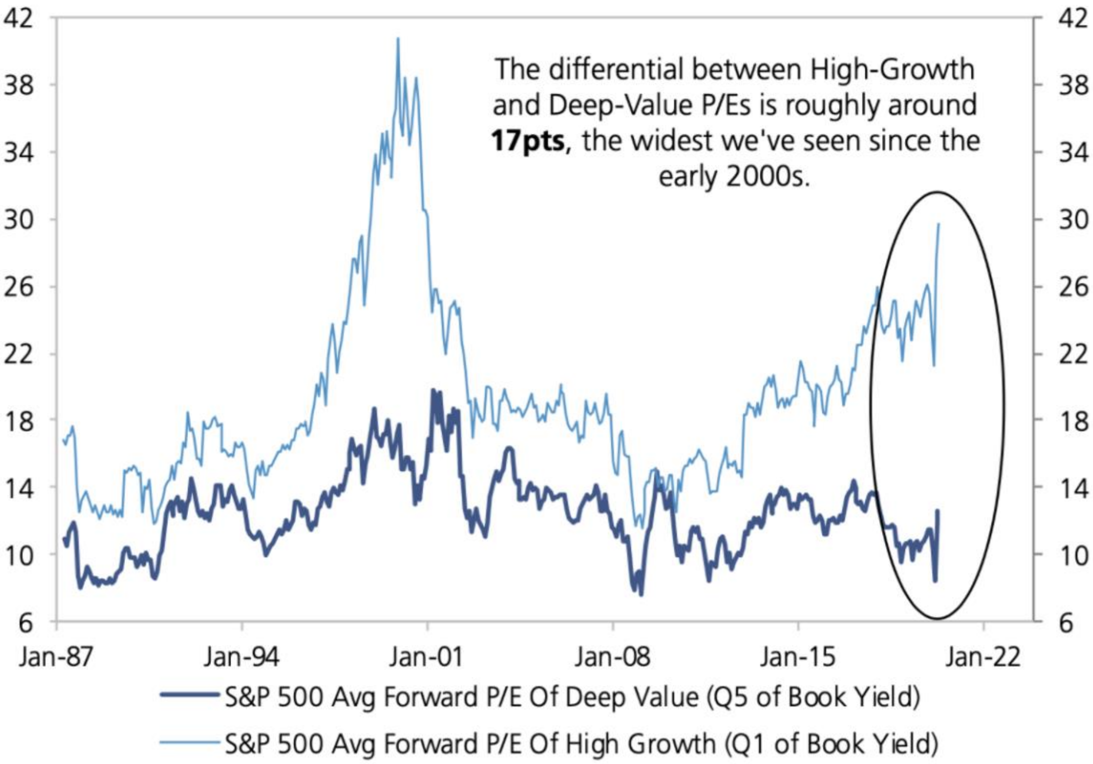


Value stocks vs. growth stocks in the current environment = The inflection is here.

With inflation = See above.

Valuation concerns = Do you want to buy high and hope they go higher, or buy cheap and hope the market finds the value? The delta right now is the highest it's been since the dot.com bubble. Q. And how did that work out? A. Good for value.

Widest Valuation Gap Between Growth and Value Stocks in 20 Years

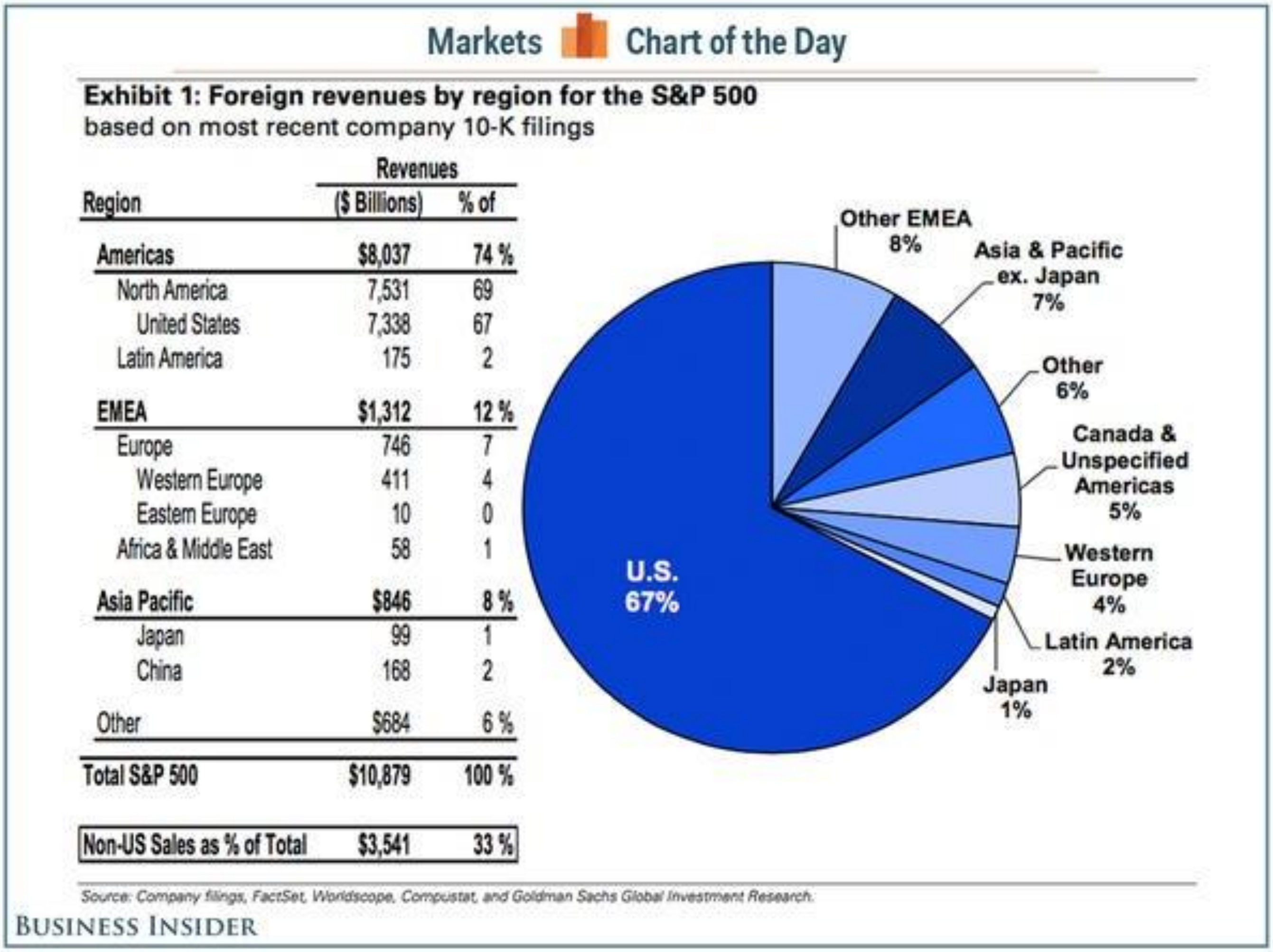


Source: FactSet, UBS

Next up, an area where I have limited expertise, but will try to formulate cogent commentary, at least from the perspective of a U.S. equities analyst.

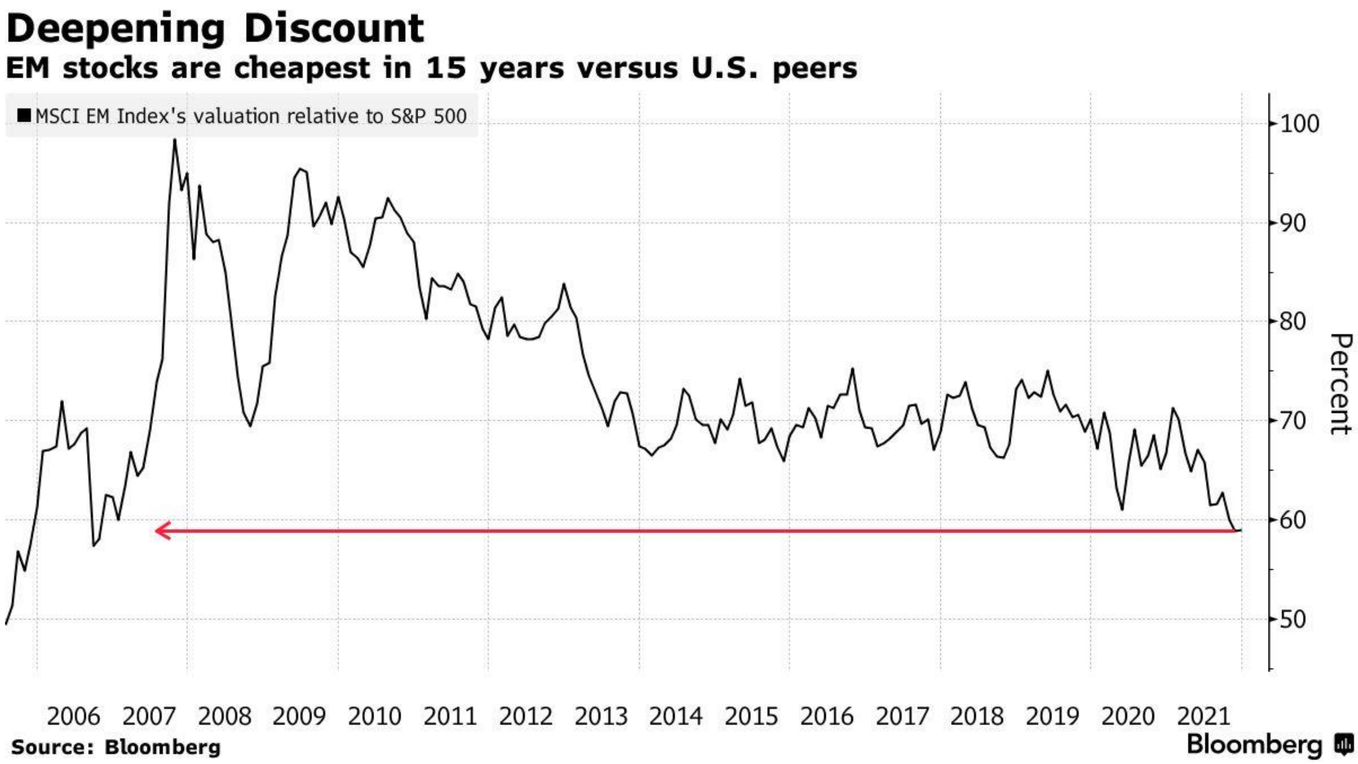
Potential direction of the US dollar and the impact for currency risk in overseas investments (e.g., emerging market equities)

The reason I'm not well versed in currencies is because most of the companies and sectors I've covered over time had a limited (less than 20%) exposure to dollar fluctuations. It was usually a few cents per quarter that was noise to most of us, with no clear signal.

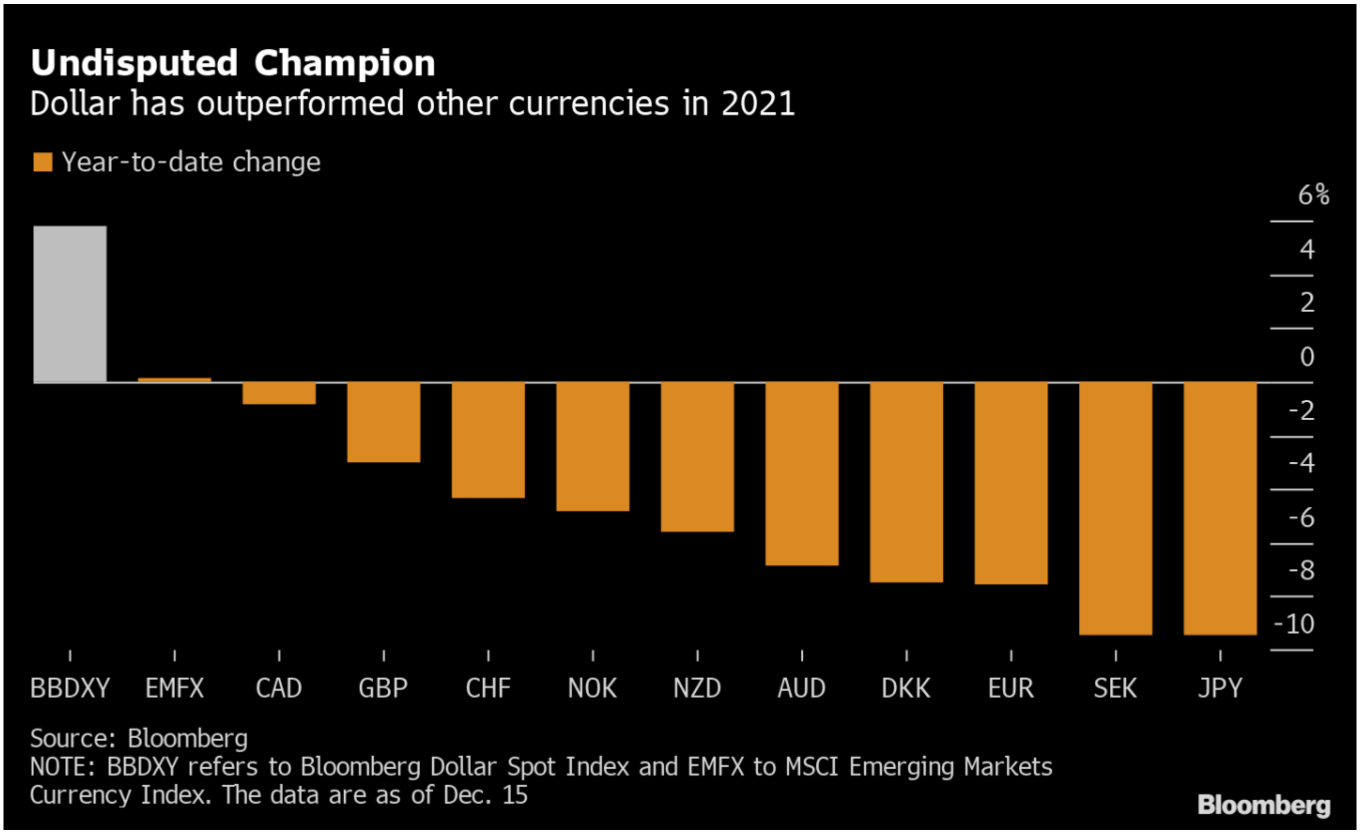


Region	Revenues ($ Billions)	% of
Americas	**$8,037**	**74 %**
North America	7,531	69
United States	7,338	67
Latin America	175	2
EMEA	**$1,312**	**12 %**
Europe	746	7
Western Europe	411	4
Eastern Europe	10	0
Africa & Middle East	58	1
Asia Pacific	**$846**	**8 %**
Japan	99	1
China	168	2
Other	$684	6 %
Total S&P 500	**$10,879**	**100 %**
Non-US Sales as % of Total	**$3,541**	**33 %**

Last year was not a good one for emerging market equities, largely because a pandemic challenge here is a four, and in an emerging or frontier economy it's an 8. You think we have inflation here, imagine what that looks like in Central America or some small Asian country. Same as with inflation. These economies are much further out on the tail than we are, that's both good and bad. But what it's led to is value not seen in 15 years, right at a time when the US is probably peaking.



Is the U.S. Dollar about to be supercharged by the Fed as the headlines all read? If you follow the traditional mindset that higher rates attract global flow of funds denominated in foreign currencies, and those currencies need to be converted to dollars, then yes, King Dollar shall reign again in 2022.

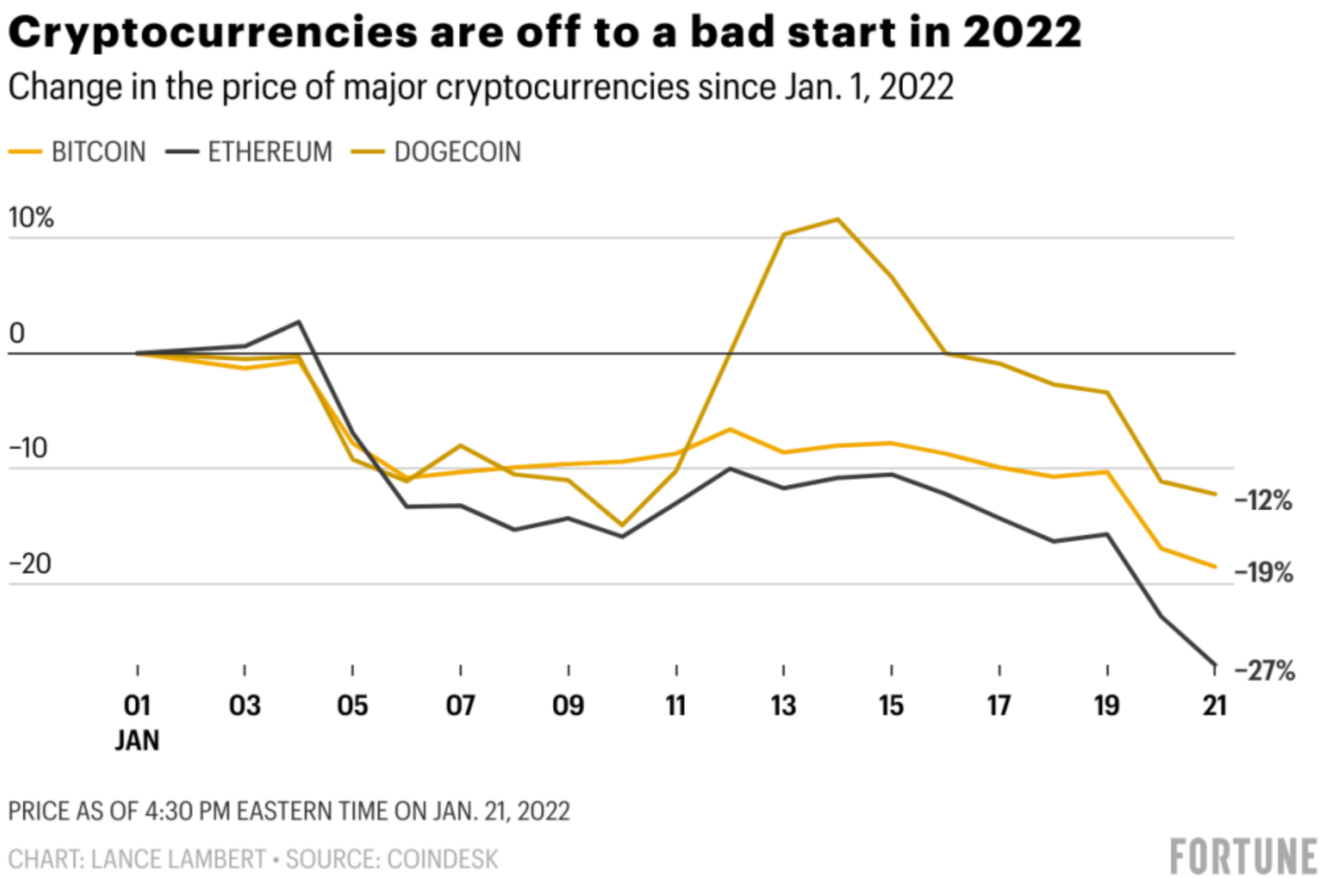


Potential direction of the US dollar and the impact for currency risk in overseas investments (e.g., emerging market equities)? = Dollar strengthening is the strong consensus and with rates almost guaranteed to go up, I can't disagree. Emerging markets did not have a great 2021 and if past is prologue, the headwinds should persist. That said, the asset class quilt says a lot, and that which is last, is often first the next year.

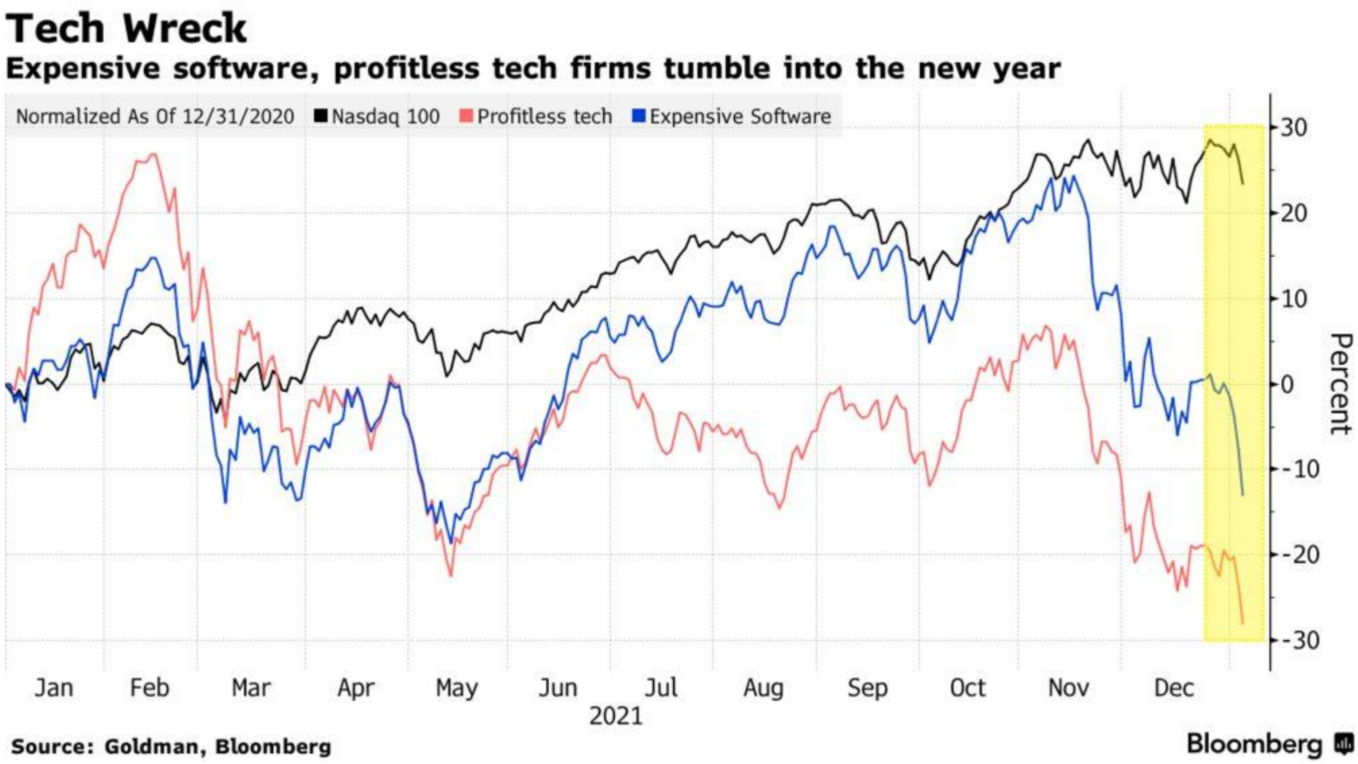
Onward still for a great question for every investment committee, market strategist, financial advisor, and client…big or small. Is now a time to draw down risk and keep some dry powder? Three answers to that question. Yes, yes, and yes, for the Great Wave is here.

Before anyone gets too excited, let me be clear, we just got through the first few innings of this new ballgame at a quick clip. Doesn't mean there isn't a long way to go, it's simply that a lot of speculation and excess has been quickly taken out of the market. SPACs have crashed…

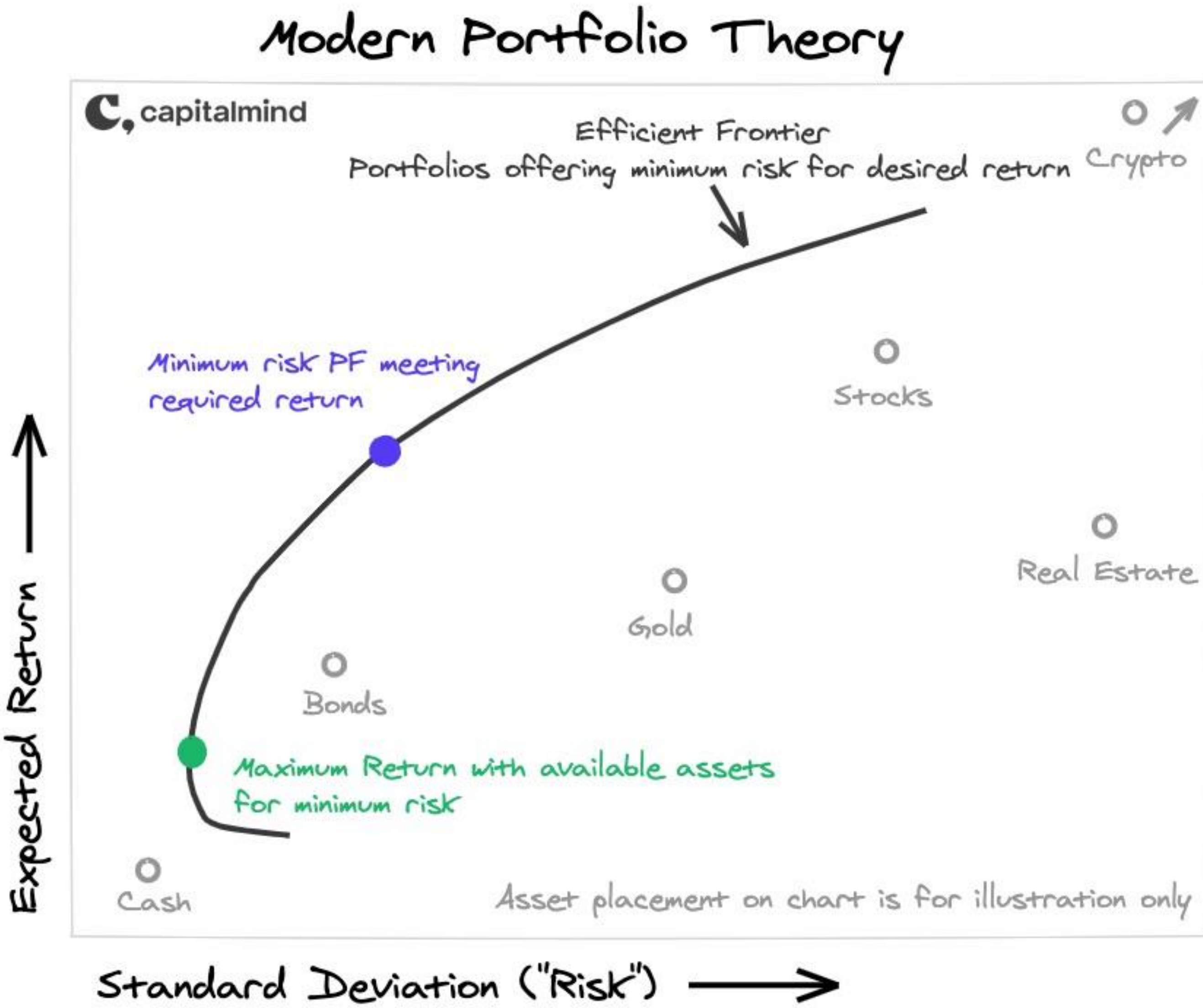
Crypto is getting hit with the ugly stick…



And profitless innovation companies have gotten eviscerated.



And while that is a lot to absorb, the indexes and higher-grade equities and bonds have been doing well, all things considered. So, in a strong way, risk has drawn itself down. Should any of these asset classes have been a large part of an institutional grade portfolio, no way. If they were in the 10% to 20% risk on sleeve, you probably got hit to the tune of 5% to 10% of total assets. No small number, but your ship isn't sinking…yet. This chart of the efficient frontier works because it shows Crypto almost off the upper right corner of the page.



Back to the original question, Is now a time to draw down risk and keep some dry powder? = A prudent person would say, at this point in the cycle, with everything we know about the returns we've seen across asset classes in the last two years, and the fact that the markets are about to lose a trillion-dollar buyer, it's indeed time to tack the ship. Does this mean kill the engines, or throw it into reverse, no. Simply make the changes on the margin to give yourself, or the institution or endowment you act as a fiduciary for, time to catch your breath and regroup for what comes next. Aye, aye, captain.

Quick digression, I’ve seen my share of investment committee meetings and interactions among colleagues within the walls of large asset management companies. Some can be truly painful, as they become a dance of egos where nothing good gets done. I don’t know what a psychiatrist calls it, but it’s not good for the outcome. Bridgewater, the worlds largest hedge fund, has a way of doing things that are noble in their mind, but frightening as well. I don’t even want to begin to know what my “baseball card” would look like.

RADICAL TRANSPARENCY AT BRIDGEWATER: THE BASICS

Everything is recorded.
All meetings and interviews, with few exceptions, **are filmed and made public** to all employees.

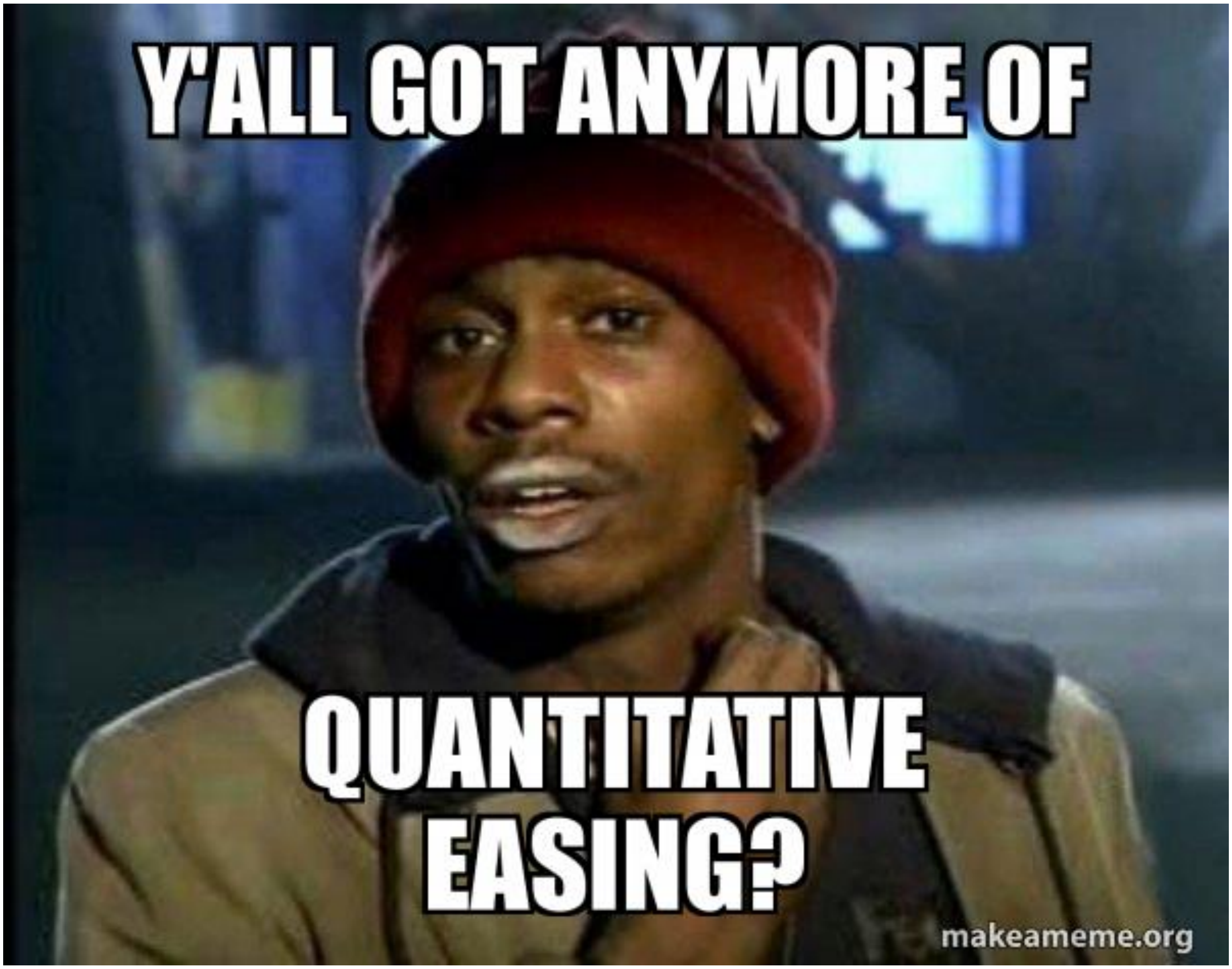
Everyone follows the "Principles."
Each employee has a copy of Dalio's exhaustive management philosophy guide, which contains **210 lessons.**

Complete honesty means nothing held back.
Talking behind someone's back makes someone a "slimy weasel," according to the Principles, and is a **fireable offense.** All tensions, even with Dalio himself, must be brought to that person.

Employees have "baseball cards."
Employees use an internal iOS app called **Dot Collector** to rate each other's attributes. Averages are collected in "baseball cards" for each member of Bridgewater.

Pain + reflection = progress.
The above equation is fundamental to Dalio's Principles. Each employee uses an iOS app called **The Pain Button** to log negative work experiences for the purpose of later discussion and resolution.

Last question before we get to a book recommendation and some career advice. Individual stock picks or interesting story stocks – whatever you might be enthusiastic about. First off, as someone who was classically trained in the art of short selling, watching a bubble burst is pretty much one of the more enjoyable things to have a sideline ticket for. Not that I look forward to seeing people lose money. But when you are wired to be a voice of reason in a world seemingly gone mad with endless quantitative easing, it’s nice to see the QE junkies get off the juice. And to be clear, that’s Dave Chapelle’s joke, not mine! But I still like it.



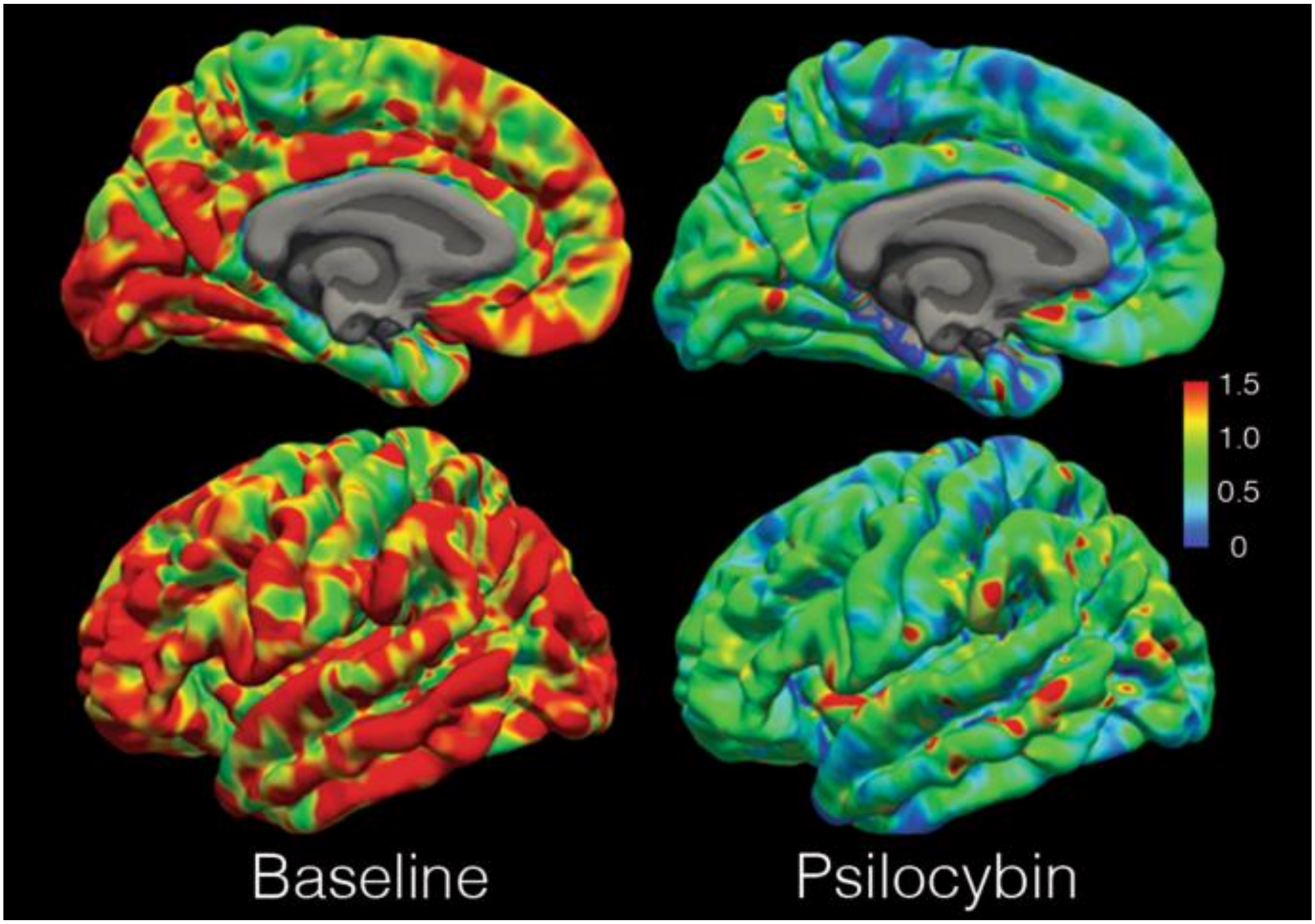
Some of the more interesting things I’m looking at, others might think of as pedestrian. But if Frank’s RedHot isn’t your thing, then maybe we shouldn’t hang out.

Another ‘exciting’ company I’ve followed for a long time is Donaldson, the maker of industrial filters that seems to have the razor and razorblade model all figured out.

An area of real interest for me is the oil sands of Canada, which only economically work when crude is trading north of $70.00. It’s such a nasty filthy thing to extract from the arboreal forests. When it works, it works. When it doesn’t it’s a bankruptcy metropolis.

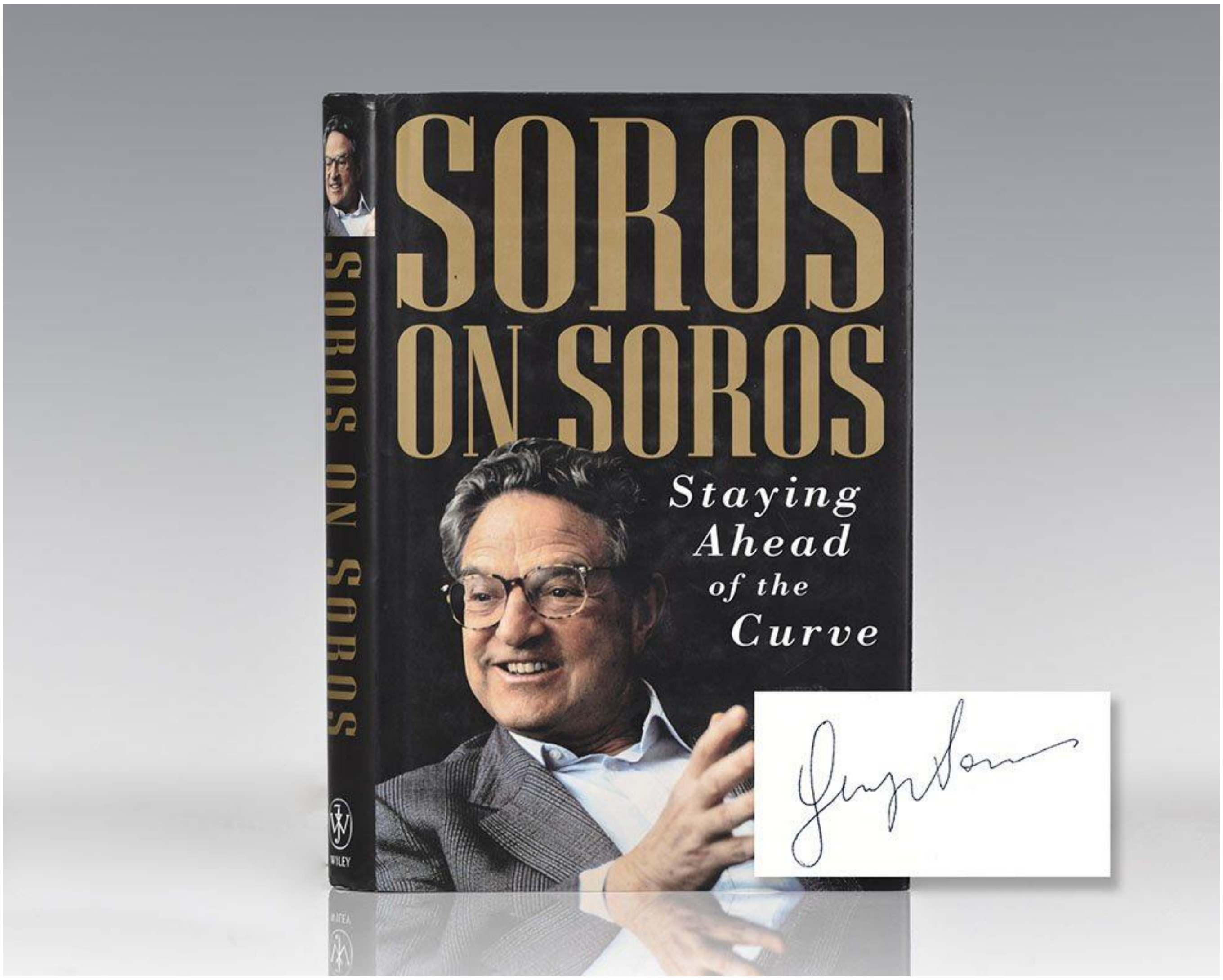
Back in the ‘new world’, the metaverse is about to get super hyped. There will be plenty of winners, much with just vaporware hype. But vaporware hype makes guys rich, and when you are retired and flying private at a young age, who cares how you made it. But the meta is going to be huge.

Personal area of interest is psilocybin, the active drug ingredient in mushrooms. I don’t think we are even out of the first inning, and the medicinal impact proper dosing can have will be bigger than what THC and CBD claim to offer. That’s a serotonin filled brain on the right.



There you have it, my Individual stock picks or interesting story stocks – whatever you might be enthusiastic about. = McCormick, Donaldson, Canadian oil sands, the Metaverse, and psilocybin. Just to get us started.

Required reading for the finance and markets focused student: *Soros on Soros, Staying Ahead of the Curve.* Reflexivity is indeed a real thing.



Prepare to have an interest in something completely outside of finance. It worked for Pete Muller…

It also worked for David “D.J. D-Sol” Solomon…

Finally, have a side gig, that can maybe become your real gig someday.