

Unintended Consequences

2nd Quarter 2022 Letter

April 26, 2022

A lot happened this quarter! But first, some good news - our recent quarter performance. As you know, we have focused the last 12 months on **portfolio resiliency**. We were a bit early, but now 40-year high inflation and a bursting tech stock bubble are mainstream concerns.

In Q1 2022, stocks and bonds went down together on inflation concerns. Many of the hot stocks of the post-pandemic tech bubble are down well over 50% from their highs (Exhibit A). Even with this decline, the S&P 500 Price-to-Sales ratio **is still far above its late 1990s dot.com bubble peak**. This bubble is likely to deflate further, but a land war in Europe dampens our conviction. More on this later.

Bonds had the worst quarter in decades – the last four decades! The worst forecast in U.S. Federal Reserve history was that U.S. inflation would be temporary. In 2Q 2021, our view was that sustained inflation was coming, and we started calibrating for it.



“Russia is a big gas station for W. Europe” page 3

“In addition to [short duration-high quality](#) bonds, [managed futures](#), [cheaper global equities](#), we added a [gold exchange-traded fund](#) across accounts in the 3rd quarter to hedge inflation risk. It’s impossible to predict the pin that pops this high-profile asset bubble, but we have to be prepared for a range of outcomes.”

November 17, 2021 – Spectra Letter “[The Value of Good Brakes](#)”

Actions speak louder than words, and this was an excellent quarter to test the implemented hedges outlined above. Last quarter, our defensive [short duration-high quality](#) bond strategy dramatically outperformed the Bloomberg US Aggregate and Municipal Bond indexes. Our [managed futures](#) manager returned +30% in the 1st quarter

and has added another +10% so far in the 2nd quarter. Our [cheaper global \[value\] equities](#) outperformed the S&P 500 and other equity styles. Adding further performance ballast, our selected [gold exchange-traded fund](#) returned +5% in the 1st quarter.

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Unintended Consequences

The world has quickly become very complex. For the last year, we have adapted to the consequences of excessive government stimulus. While attempting to pound flat the risks of inflation and a technology bubble, a war in Europe entered the investment landscape. So inside, we whack a different mole exploring the unintended consequences of this conflict and sanctions on Russia.

Background

Ukraine is a border country that separates Western Europe from Russia. The soil and climate of Ukraine are perfect for growing wheat, sunflower seed, and corn. But this culturally complex breadbasket country is also a military pathway for the West to attack Russia. A pathway that exacts a heavy toll, first on the Ukrainian people but then on the Russian military - most notably in WWI and WWII.



Blue sky and fields of wheat/sunflowers inspired the Ukrainian Flag.

It is hard to guess what conversations Putin is having with himself. But there seems to be a consensus among geopolitical experts that Putin is not rebuilding the old U.S.S.R. Instead, his intentions could be to plug several hard-to-defend pathways on Russia's 3600-mile western border.

That could mean that Putin's master plan includes scooping out a military occupation zone in Moldova, Romania, Poland, Lithuania, Latvia, and Estonia (Exhibit B). No one knows how long this war will last or the extent it may evolve. But sadly, we cannot rule out the risk of a broader conflict.

We can conclude that the geopolitical pendulum is swinging back to a multi-polar [East vs. West] world. Except for the Global War on Terrorism, geopolitics has effectively been on cruise control since the end of the Cold War. What worries us is that sufficient time has passed for diplomacy muscles to atrophy. And a shift back to a multi-polar ecosystem has serious implications for national security, trade, and global investing.

Energy

By now, you have heard that Russia is a big gas station for Western Europe. The scale of European dependency on Russian oil, gas, and coal is a major problem. Borrowing from Oaktree Founder Howard Marks' memo a few weeks ago, this table sums it up quite well.

	Europe			Russia		
	Produces	Consumes	Net	Produces	Consumes	Net
Oil (bbl/day)	3.6 mm	15.0 mm	(11.4 mm)	11.0 mm	3.4 mm	7.6 mm
Gas (cu met/year)	230 bn	560 bn	(330 bn)	700 bn	400 bn	300 bn
Coal (tons/year)	475 mm	950 mm	(475 mm)	800 mm	300 mm	500 mm

Source: "The West's Green Delusions Empowered Putin," Michael Shellenberger, Common Sense with Bari Weiss, March 1, 2022. Some data is approximate or rounded. (Common Sense is probably as tendentious as other media outlets, but I have no reason to believe the data is inaccurate.)

Life is full of tradeoffs. And the tradeoff to living in a more ecological society deepened Europe's reliance on Russia for fossil fuels. If reversing this dependency is the end game, it will take time, diplomacy, and capital – a lot of each. Some strategists have suggested that certain countries may break away from E.U. sanctions to keep their lights on (Exhibit C).

Russian crude oil is still flowing into Western Europe. Current challenges include vessel logistics, satisfying Putin's payment preferences, and oil/gas pipelines in war zones. As this conflict evolves with a risky crude and natural gas supply, it would not surprise us if oil tops \$150 - \$175 per barrel. Because oil is in everything, short-term or persistent high prices could trigger an energy crisis and global recession.

The United States has better oil options than Europe. The shale revolution helped the U.S., but many of our high-tech refineries import different crude grades from the Saudis. U.S. energy independence is possible, but not without reengineering our refineries for lower grade shale oil. Again, this requires time, money, and diplomacy to navigate the U.S. environmental lobby.

Food and Agriculture Inputs

Combined, Russia and Ukraine supply more wheat to world ports than the U.S. and Canada. There are many other crops Europeans depend on sourced from Eastern Europe (Exhibit E). What makes this food picture worse is that Russia is a heavyweight exporter of finished fertilizers. Nitrogen, potassium, and phosphorous are critical for crop yields in less fertile counties like Africa, Brazil, and the Middle East. Like energy, U.S. farmers are in better shape to adapt and source fertilizer from North America.

We could add metals, minerals, and a basket of chemicals (Exhibit E) to this list of inputs exported from Russia. The question is, **how did the world become so dependent on Russia?** The simple answer is that Russia has no environmental protection efforts. Over time, Russia has become a global trading powerhouse for inputs with toxic by-products that many countries shun. The "ideology in Russia is that environmental protection is only for rich countries and that when Russia is rich, it will be time to solve environmental problems," declared Aleksei Yablokov, President, Center for Russian Environmental Policy, 2005.

Central Bank Sanctions

Except for transfers to facilitate energy purchases, G7 central banks have frozen Russia's gold, foreign currencies, and debt instruments. The United States, European Union, and Japanese central banks have weaponized foreign reserves. China and India declined to participate in the financial sanctions program, which gives Russia workaround options. With these measures, geopolitics expert Peter Zeihan asserts, which seems credible, that these sanctions on Russia are more severe than all global sanctions combined.

Only time will tell, but the unintended consequences of seizing Russia's reserves could threaten the U.S. dollar (US\$). In the past, the U.S. has sanctioned Afghan reserves, and the U.K. has seized Venezuelan gold. But this is the first time central bankers have frozen the reserves of a nuclear-armed G20 nation. This matters because the US\$ is the global reserve currency. Foreign governments that are not strong U.S. allies are likely considering onshoring their reserves and gold, thereby reducing the volume of US\$ demand. A positive

event for our gold position as this move could strengthen the demand for gold as a neutral reserve currency.

Deglobalization

Let's start with the punchline. The world is well past peak global trade. Over the last 40 years, foreign sourcing of cheaper labor, inputs, and finished products has changed the fabric of commerce. But the last decade, businesses have struggled with higher offshore wages and poor quality. Onshoring labor and manufacturing were already in motion before this war. When Covid lockdowns started, companies found that they struggled to source critical inputs. Now with the economic break of Russia, and China and India opting out of important sanctions, the velocity of deglobalization is likely to speed up. The NAFTA trio of Canada, the U.S., and Mexico will undoubtedly strengthen, but understanding the winners and losers of this trend is high on our to-do list.

Recalibrating

We are recalibrating but not making significant changes in response to this conflict. For example, we added to an existing gold ETF position across accounts in March. This quarter, we bought a fertilizer stock and added to an existing shale oil stock in our U.S. Value Strategy. Changes are being considered as the trend toward deglobalization strengthens – more to come.

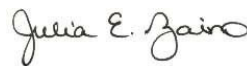
There has always been a connection between war and finance. Investing that reflects a worst-case war scenario has been a poor strategy (Exhibit D). Today, the highest priority investment risk is persistent high inflation, Fed policy errors, and further unwinding of speculative excesses. This quarter was a good test of portfolio resiliency specific to these risks, and we will adapt further as events unfold.

Lastly, this month marks our 5th Year in business. We struggle to find words that express our gratitude for your business, advice, and feedback. Thank you!! It is an absolute pleasure to work for like-minded investors, and we look forward to serving your family for many years to come.

Very truly yours,



Scott A. Roads
Founding Principal



Julia E. Zaino
Principal

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Exhibits

A. Tech bubble bursting

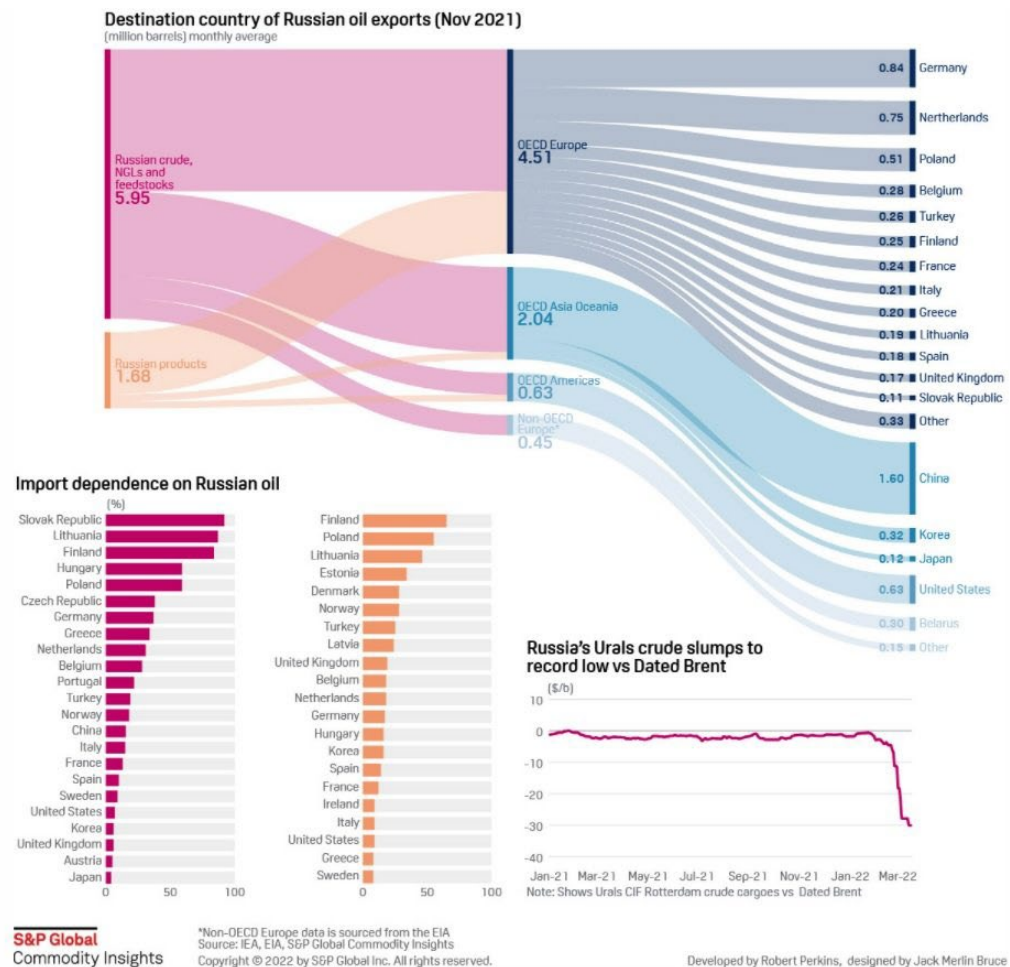
Symbol	Company	Price 4/25/2022	Price 52 Wk High	% Return Since 52 Wk High	Price on 10/1/2021	% Return 10/1/21 to 4/25/22
AMZN	Amazon	\$ 2,921.48	\$ 3,773.08	-23%	\$ 3,283.26	-11%
FB	Meta / Facebook	186.99	384.33	-51%	343.01	-45%
GOOG	Google	2465.00	3042.00	-19%	2729.25	-10%
NFLX	Netflix	209.91	700.99	-70%	613.15	-66%
MSFT	Microsoft	280.72	349.67	-20%	289.10	-3%
AAPL	Apple	162.88	182.94	-11%	142.65	14%
ZM	Zoom Video Comm	102.44	406.48	-75%	267.51	-62%
PTON	Peloton	20.41	129.70	-84%	86.71	-76%
TSLA	Tesla	998.02	1243.49	-20%	775.22	29%
SNAP	Snapchat	29.91	83.34	-64%	75.25	-60%
SHOP	Shopify	459.21	1762.92	-74%	1350.76	-66%
DOCU	Docusign	89.95	314.76	-71%	257.77	-65%
PYPL	PayPal	87.78	310.16	-72%	264.65	-67%
NVDA	NVIDIA	199.02	346.47	-43%	207.42	-4%
PINS	Pinterest	20.00	81.77	-76%	52.62	-62%
ROKU	Roku	101.41	490.76	-79%	314.46	-68%
SPCE	Virgin Galactic	8.33	57.51	-86%	23.83	-65%
HOOD	Robinhood	10.39	85.00	-88%	41.90	-75%
RIDE	Lordstown Motors	2.40	15.80	-85%	6.53	-63%
ETSY	Etsy	102.06	307.75	-67%	204.37	-50%

Source: Bloomberg

B. Russia's Desired Borders. Source: Peter Zeihan <https://zeihan.com/>



C. Destination country of Russian oil. Source: S&P Global

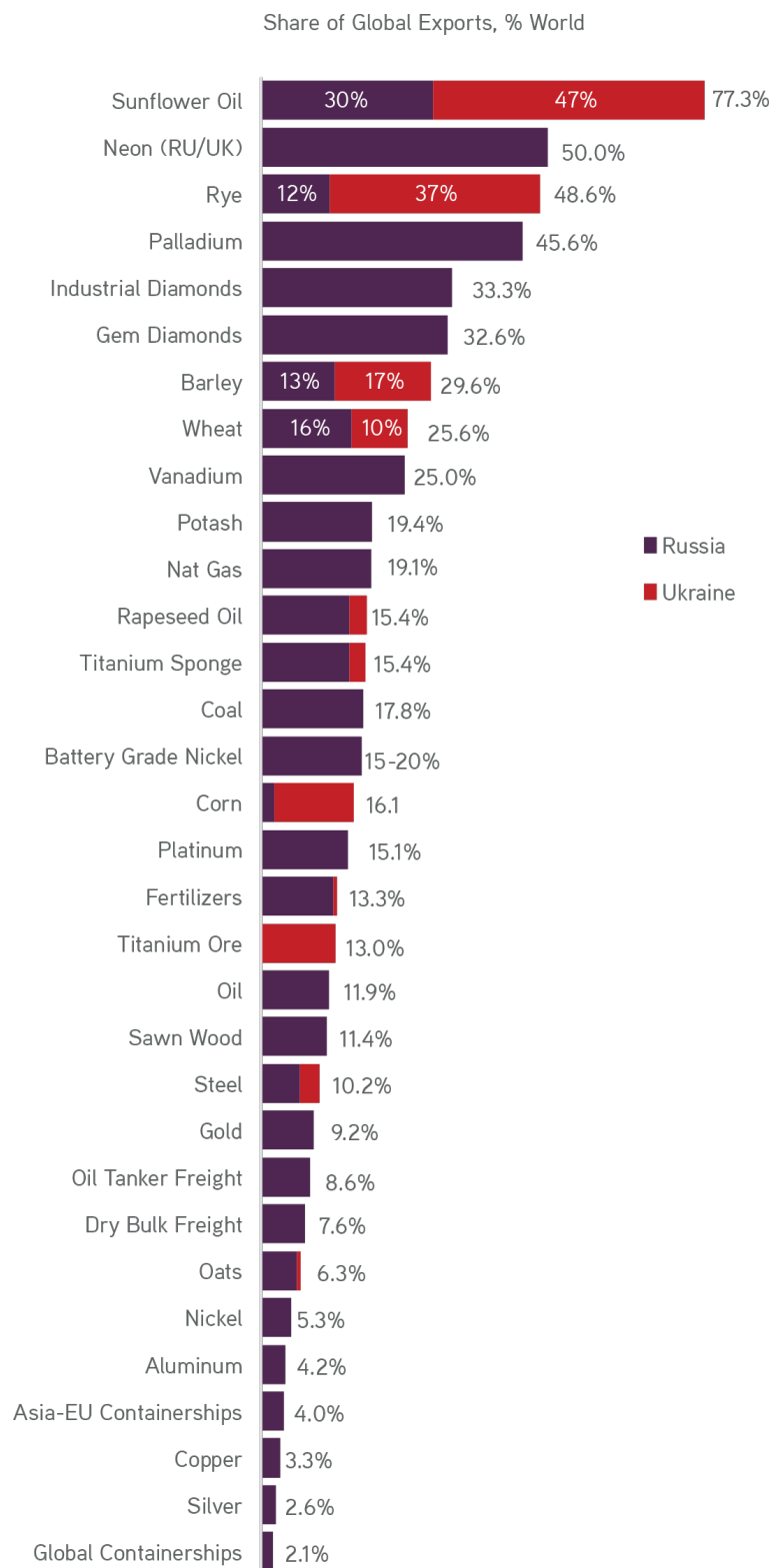


D. War and S&P 500 Gain/Loss. Source: InvesTech Research/Jim Stack

Crisis Events						
DATE	WAR / POLITICAL EVENT	S&P 500 Gain/Loss				Bear Mkt
		1mo	3mos	6mos	12mos	
05/10/1940	Germany Invasion of France	-25.8%	-14.5%	-5.9%	-20.9%	Y
12/07/1941	Pearl Harbor	-4.1	-12.3	-10.4	-0.9	Y
06/25/1950	Korean War	-4.6	5.7	10.0	17.6	-
10/14-28/1962	Cuban Missile Crisis	5.6	14.5	20.8	27.0	-
06/05-10/1967	6-day Middle East War	1.7	4.9	6.1	11.2	-
10/06/1973	Yom Kippur War	-4.5	-10.0	-15.3	-43.3	Y
04/02/1982	Falklands War	1.2	-6.5	6.0	32.9	Y
04/15/1986	U.S. Bombs Libya	-1.2	-1.5	0.6	19.9	-
08/02/1990	Iraq Invasion of Kuwait	-9.3	-12.3	-3.5	8.9	Y
01/17/1991	U.S. Launches Operation Desert Storm	16.7	23.5	20.6	32.5	-
09/11/2001	9/11 Terrorist Attack on U.S.	0.4	4.0	6.9	-16.8	Y
03/20/2003	U.S. Launches Operation Iraqi Freedom	-2.2	13.9	18.6	27.0	-
08/18/2014	Annexation of Crimea by Russia	2.0	4.1	6.5	6.4	-

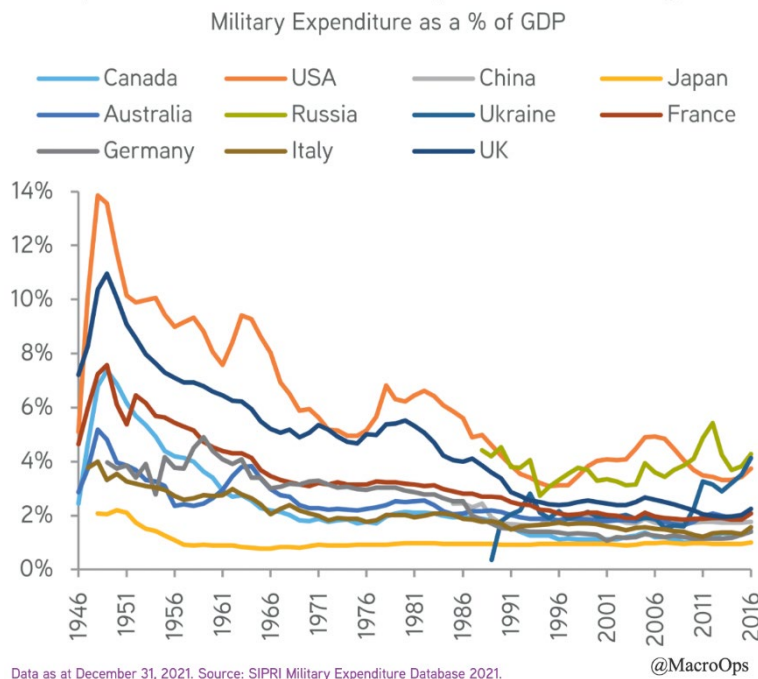
InvesTech Research

E. Russian/Ukraine Exports – Commodities, Precious Metals, Agriculture, and Rare Gases. Source: KKR



F. Trends In Defense Spending as a % of GDP. Source: @MacroOps

Defense Spending Has Fallen Consistently in the Post-WWII World, But Recent Events Are Likely to Mark a Turning Point



Important Disclosures:

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