MATHIASEN
& CHENG

Dear clients and friends,

At my parent's place, a set of books nestled on my father's bookshelf. A series of six books, each a few inches thick, white covered but now showing a hint of yellow with a thin layer of dust. They sit at the top of the shelf alongside a childhood picture of my sister and me. They have been there forever since I can remember.

But I only came to understand what they are at a much later age. These are several operation manuals for a model of mainframe computer — a kind of computer server launched thirty-something years ago that performed the function of a Google Drive today, yet occupied the size of a high-school classroom.

This tells you everything you need to know about my father. Bespectacled, modest, and a little humped from all those years sitting in front of his desk, my father is a computer infrastructure engineer. He worked for the same company for his entire thirty-year-plus career, initially as a programmer, and gradually climbed to some managerial position.

If there is a spectrum of fathering style between "a loving father" and "a cool dad", he is certainly on the extreme end of the former category. On a typical Sunday, he would go to church, talk to my grandma, then sit down at his computer to calculate our family finances, pay bills through some old-fashioned telephone systems, and then join my mother for an episode of drama on his massage chair. For most of my childhood, I don't remember him dabbling with anything adventurous or exciting.

Except there is one thing I don't often remember: the first Windows PC was only launched in the mid-1980s.

It was a handful of years before I was born. These computers took 3–5 minutes to get boot started, with unreliable or non-existent internet and, seemed to me, offered nothing more other than a game of Minesweeper. It was before the internet bubble when everyone dreamt of fancy applications and before working as a Silicon Valley engineer was cool. This metal box must have appeared so stupid and unstable, with a commercial value yet to be proven.

Considering how spreadsheets and the Internet today have become an essential part of my everyday work and how they have always been dependable for most of my adult life, it is easy for me to assume that it has always been like this.

But what for me is a given was something entirely new for my father — it came about only in his twenties. Yet, for some reason, my father decided back then to take a deep dive into the technology. He kept his head down and read about everything from the memory chips to the motherboard to the network infrastructure; he also defied his family's expectation to return to the family business, became the first child in the big family to obtain a college degree (which was then far from common), and eventually made a career out of it (plus marrying a beautiful woman — my mother — in the process).

In my mid-twenties, I gave up learning that new Snapchat or TikTok. But, in his mid-twenties, my father forged his own path.

If I think about this "generational context", he was probably a much cooler guy in his generation than I am in mine.

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Of course, we all know how it turned out. That stupid metal box became smaller in size and more powerful. It changed every aspect of our lives, from how we communicate with each other and how we do business.

But it is always easy to connect the dots backward, concluding something is "meant-to-be" while understating the uncertainties our previous generations faced when they were actually in that situation. It could be my father learning a then yet-to-be-proven technology, or it could be the thousands of brave entrepreneurs entering an emerging market when it was far from promising like it is today.

It was China in the 1980s. Mostly remembered by Deng Xiaoping's "to get rich is glorious", China launched its economic reform in 1978. It deregulated many of its previously state-controlled industries and allowed foreign investments. Among other factors, its low land cost and vast availability of skilled and hardworking labor quickly attracted investments from manufacturers, predominantly from Taiwan and Hong Kong.

Since then, the country has made gradual but assertive moves to an open market. It entered the WTO in 2001 and is now the world's manufacturing superpower, contributing almost 30% of the world's manufacturing output.

When we look back, it is again easy to say this is a predetermined destiny; with globalization and capitalism — and thus cost minimization — in full swing, the entrepreneurs happened to be in the right place at the right time would get rewarded.

But I am certain there is a distinct difference between reading from history books and living a life then as events unfold — it must have felt much more complex at present. I thought about how frustrating it must have been to navigate a business environment that was still experimental, regulations blurry, and infrastructures yet to be built.

I also thought about the uncertainty they must have felt in 1989, when the country's conservatives seemed to be taking over reformists, the progress toward a market-based economy stagnated, and foreign clients were starting to cast doubt.

And I thought about the loneliness they must have shared; in the early days when there were no instant messages or internet, and a long-distant call back home were charged by the seconds. And when they finally flew home once in a while, the joy of them seeing their family was overwhelmed by a matching amount of guilt, realizing how many precious moments they missed seeing their child growing up.

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There is a distinct difference between reading history and actually living life as it unravels. My father could tell me the evolution of mainframe computers to cloud servers as if they happened overnight. Similarly, with the benefit of hindsight, we learned the story of the Open Door Policy and the China economy like a neatly constructed story with clear steps 1, 2, and 3.

But **there is so much clarity looking back only because we know how things turned out!** In contrast, the present always look too complex to fit into a storybook — it comes with emotions: frustrations about the here and now, uncertainty about changes, and perhaps a bit of loneliness if we decide to do something different from our past.

## A DIFFERIENT GENERATION

So, what am I trying to get from here?

From June onward, investors have shifted their attention from inflation to a looming recession (Exhibit 1). Inflation is now expected to be contained. While the coming CPI print is forecasted to stay elevated, the market expects it to decline rapidly and level off at the 2.5–2.8% range. Meanwhile, several consumer and production indicators suggest early weakness in the US economy, and investors subsequently are pricing in a rate cut as early as March 2023.

Expecting this dovish pivot and a return to the falling-yield environment, investors reinstated their risk-on sentiment. At the time of this writing, Nasdaq is up 20% from its mid-June low, and the S&P 500 is up 15%.

It is a reasonable assumption, given this is essentially what happened the last time we experienced inflation.

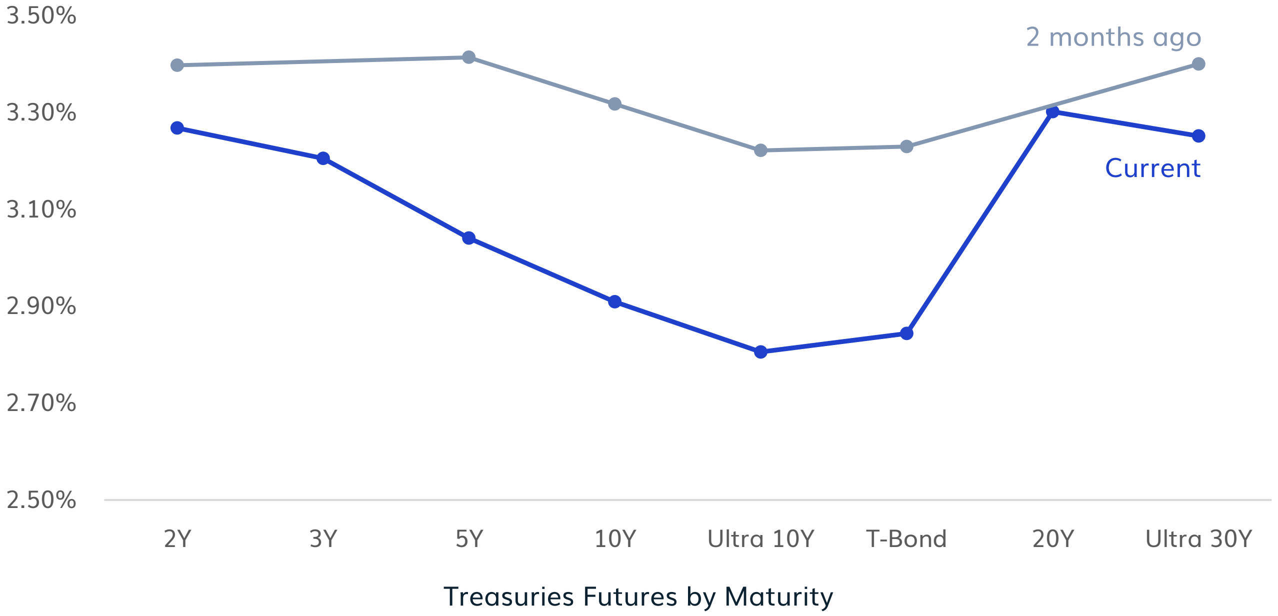
For good reasons, such as data availability and relevancy, most of the news and analysis today on inflation regimes heavily reference the Great Inflation of the 1970s. And with the clarity of hindsight, it is admittedly tempting to simplify the whole episode to simple steps 1, 2, and 3: aggressive rate hikes, recession, and eventual rate cuts.

So far, we are following a very similar path. And with prior lessons learned (not to be the “new Arthur Burns”), the FED response has been timely and forceful. The current episode, to many, will be an accelerated version of the 1970s.

Exhibit 1

**Market is pricing in a recession and steep decline in inflation**

Treasury Futures Implied Yield Curve




Source: CME Group, data as of 11 Aug 2022

But before we get comfortable with a terminal inflation rate of 2.5%, it is perhaps worthwhile to put things into their generational context.

Long gone are the days we feel uncertain about computers or globalization — we now assume they are the given, the default state of the world, the same way we assume peace, and the absence of physical walls between or within countries.

Surely, we feel frustrated and uncertain today about things too! But they are about:

- Climate change
- Reducing inequality
- Supply chain security
- Jobs protection from immigrants and refugees
- Energy independence
- Human rights
- An emerging power that might challenge an existing power and the world order it represents

The generational context we live in is so much different from that of my father. And however I look, it seems to suggest a more volatile time ahead, if not an exact reverse of what our previous generation experienced.

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It was only in August last year that Chairman Powell at Jackson Hole made some comments on inflation:

> *... Finally, it is worth noting that, since the 1990s, inflation in many advanced economies has run somewhat below 2 percent even in good times.* **The pattern of low inflation likely reflects sustained disinflationary forces, including technology, globalization, and perhaps demographic factors***, as well as a stronger and more successful commitment by central banks to maintain price stability... While the underlying global disinflationary factors are likely to evolve over time,* **there is little reason to think that they have suddenly reversed or abated***. It seems more likely that they will continue to weigh on inflation as the pandemic passes into history.*

If there were little reason last summer to rethink those disinflationary forces, it appears to us we have many reasons to do so today.

## WE HAVE FOUR DECADES OF BIAS TO OVERCOME

This is perhaps a good time to repeat a recurring theme in our Letters: most forecasts are already priced in and therefore unprofitable; while what is profitable are the surprises, which are difficult to predict by default.

In the last inflation episode, inflation has been rising since the late 1960s. After ten years of inflation, the experience and pain had been so ingrained and vivid. For a long time after The Volcker rate hikes, the market still assumed the return of inflation soon.

Bond investors stand to lose the most in an inflationary environment — they pay a large sum upfront for a predetermined stream of cashflow in the future, and the real value of this future cashflow will diminish in an inflationary environment. They, therefore, demanded a meaningful premium to compensate for taking this inflation risk (Exhibit 2).

But the realized inflation had *consistently* surprised on the downside! Taking inflation risk, or "selling inflation" (think selling insurance), had been a handsomely rewarded investment after 1980.

**We believe we are in the opposite situation today.**

After spending the past few decades battling disinflation, we assumed it to be the given environment. Soon after the FED made its 75-point moves, the market assumed it would suffice and subsequently sold assets that would benefit in an inflationary environment, such as commodities and breakeven inflations. It resumed their confidence votes in growth stocks. This bias might also be institutionalized in organizations with mandatory sizable allocations into bonds.

In other words, the market is heavily skewed toward our consistent disinflationary environment being continued. Few expect a prolonged inflationary environment, a slower but longer rate hike cycle, **nor a wider swing of inflation readings, in both directions, going forward.**

Exhibit 2

**After 1980, the market rewarded inflation risk-taking**


Source: FRED, St. Louis Fed; Mathiasen & Cheng

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At times of change and uncertainty, we tend to look back to our past — our history provides a sense of clarity and security that the present is always lacking. But we should remember this sense of assurance arises because we know exactly how things turned out.

While returning to a falling yield environment is one of the possible scenarios, we believe the case for diversification — particularly, buying inflation as a balance to a stock/bond portfolio — remains strong today.

Stay invested, but diversify,

Ryan

12 Aug 2022