One morning in 1995, Mr. McArthur Wheeler decided to rob a bank in Pittsburgh. The forty-four year old man did not wear a mask or a disguise, and in fact smiled at the bank’s surveillance cameras as he walked out, confident that the lemon juice he smeared on his face would conceal his identity. According to his rationale, one can use lemon juice to write invisible letters that become visible only when the paper is held close to a heat source. Mr. Wheeler concluded that the same chemical properties would apply to his face. By smearing lemon juice on his face, he thought that the bank’s security cameras would not see his image. That day, he robbed not one, but two banks in Pittsburgh. A few hours later, the police obtained the surveillance tape and played it on the evening news. An hour later, an informant identified Mr. Wheeler in the news video and contacted the police with the man’s name. The police arrested McArthur the same day. During his interaction with the police, Mr. Wheeler was incredulous on how his ignorance had failed him.¹

The confidence displayed by Wheeler in his attempt to foil the security cameras with lemon juice on his face was extraordinary, if not insane. He acted confidently but without competency. Academic studies have demonstrated that the less competent an individual is at a specific task, the more likely they are to inflate their self-appraised competence in relationship to that task. As Charles Darwin once said, “Ignorance more frequently begets confidence than does knowledge.” One finds it easy to quickly dismiss Wheeler’s inept actions as foolish, but confidence derived from ignorance is not limited to amateur bank robbers. In fact, overconfidence pervades almost every aspect of today’s financial markets.

According to Jeremy Grantham of GMO, a value-oriented investment firm, simultaneous bubbles exist across all major asset classes for the first time in U.S. financial markets. ² First, Grantham believes that the U.S. is participating in the broadest and most extreme global real estate bubble in history. Today houses in the U.S. are at the highest multiple of family income ever, even surpassing the disastrous housing bubble of 2006. Second, market participants are now exhibiting the most exuberant and crazy investor behavior in the history of the U.S. stock market. In Grantham’s opinion, the U.S. market today has the greatest buy-in ever to the idea that stocks only go up, which is the real essence of a bubble. Third, Grantham sees one of the highest-priced bond markets in U.S. history. Compounding these concerns, Grantham notes that the United Nation’s index of global food prices is at an all-time high.

The combination of rising commodity prices coupled with deflating asset prices, which last occurred in 2008, will lead to economic pain. The country’s financial leadership should know that multiplying these risks will magnify the total shock to the economy if damage across three separate asset classes occurs simultaneously. The economic and financial dangers that now build from multiple asset class bubbles do not appear to be considered particularly dangerous by the U.S. Federal Reserve, the country’s central bank. Frighteningly, the investment thesis of most market participants hinges on their misplaced confidence in the ability of the country’s financial leadership to control market economies. U.S. markets have experienced three great asset bubbles in just the past twenty-five years, a direct outcome of the Federal Reserve’s easy monetary policies. One wonders at the level of confidence investors place in our

¹ Kate Fehlhaber, When Life Gives You Lemons, Quartz, May 19, 2017.
² Jeremy Grantham, Let the Wild Rumpus Begin (GMO Viewpoints, January 20, 2022), 4-5.
central bank when it has repeatedly allowed these events to unfold. The Federal Reserve is not ignorant of asset bubbles, but rather overly confident in their ability to manage bubbles.

Despite the Federal Reserve’s misplaced confidence in their ability to control market economies today, one should understand the original purpose behind the creation of this institution. Back in 1900, more than 20,000 banks operated in the United States, compared to fewer than 6,000 banks today. When people deposited money in a bank, the bank did not just store the cash in a vault—the bank profited by lending most of these funds to businesses and individuals and charging interest on these loans. Banking regulations required banks to keep a certain percentage of their deposits, called reserves, in ready cash. Banks in small towns often deposited some of their reserves in larger city banks to earn interest, but they could quickly call back their reserves when needed. The city banks in turn usually deposited part of their required reserves in the biggest banks. Most reserves that flowed up this chain of banks ended up in New York City’s Wall Street financial institutions, the largest banks of all.

Wall Street banks made loans to railroads, large corporations, and even to the U.S. government. They also invested in stocks and bonds. In this way, Wall Street financed much of the country’s booming industries of the nineteenth and early twentieth century. When markets functioned smoothly, money from bank reserves flowed up the chain of banks to Wall Street and then down the chain in the form of profitable interest. But markets did not always operate smoothly. One problem was the frequent shortage of money in circulation. To meet an increase in the demand for loans, local banks had to occasionally call back reserves they had deposited in city banks. In turn, these banks then sometimes called back their reserves from the chain of larger banks.

Unlike many countries in Europe, the United States did not operate with a central bank—President Andrew Jackson refused to recharter the Bank of the United States in 1836. Therefore, no national central bank managed the supply of money or acted as a “lender of last resort” to keep banks operational when they temporarily ran short of cash. Bank panics often occurred during the nineteenth century. Such events suddenly materialized when depositors, acting on real or imagined fears, ran to their bank to demand their cash deposits back. People panicked easily because if their bank failed, they would lose all the money they had deposited. Unlike today, no government insurance program guaranteed bank deposits. “Bank runs” quickly wiped out the reserves of banks and often caused them to fail even though they might still hold solid assets. A panic could start among small rural banks and spread up the chain of banks, as well as travel down the chain after the failure of banks on Wall Street.

The financial markets could also cause bank panics. If the stock market crashed, a bank panic could result. During the 1800s, at least five major bank panics erupted, followed by economic depressions of varying lengths and severity. During the summer of 1907, several Wall Street bankers devised a plan to capture a controlling share in the stock of the United Copper Company and drive up its price. But their plan fell apart, and the company’s stock plunged in value. One investor in the scheme was the president of the Knickerbocker Trust Company, a new type of bank that was only lightly regulated. Trust companies conducted regular banking operations but also extended riskier loans and speculated in the stock market. Early in October, Knickerbocker depositors learned that their bank’s president had invested in United Copper stock. This news caused a run on the trust company by depositors who feared it had lost money and would fail. Although Knickerbocker itself had not invested in the scheme and was stable, the trust company still ran out of cash to pay off its panicked depositors. Knickerbocker Trust subsequently closed its doors, and a full panic began. Depositors in other New York trust company

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banks started withdrawing their money. Banks throughout the banking chain began calling back their reserves from Wall Street to guard against a run on their deposits.

Wall Street bankers turned to J.P. Morgan, who called a meeting at the Morgan Library. He assembled the city’s commercial and trust company bankers, put them in separate rooms, locked the front door, and kept the key in his pocket until they finally negotiated a deal. Morgan’s deal-making finally stopped the panic on Wall Street, but unfortunately serious economic damage had already spread across the country. The resulting depression of 1907 was severe, but probably would have been greater if the bank panic had continued. After the Panic of 1907, there was widespread agreement that a central bank was needed to manage the money supply and to be the “lender of last resort” to stop bank panics.

Edward Griffin, in his book, *The Creature from Jekyll Island*, details the origin of the Federal Reserve. In November of 1910, a small group of financiers boarded a private railway car in secrecy. Of the six passengers, five of them were representatives of private banks. This small group travelled by rail from New Jersey to meet at an island off the coast of Georgia at a private retreat named Jekyll Island. The group intended to address several pressing issues, including how to allow the money supply to expand so that they could retake control of the industrial loan market. Most bankers, including Morgan, wanted a private central bank controlled entirely by bankers. By contrast, the political establishment wanted a central bank under the control of the federal government. After Woodrow Wilson won election as president in 1912, he insisted that the central bank be a public agency directed by government officials appointed by the president. Bankers objected to President Wilson’s demand for federal control of the central bank and argued that the bank would be controlled by politicians who would follow the policies of whichever party was in power.

Despite the objections, President Wilson signed the Federal Reserve Act into law on December 23, 1913. The Federal Reserve Banks were to be “lenders of last resort” for U.S. banks and could issue Federal Reserve Notes, paper currency redeemable in gold, to make the money supply more “elastic” or expandable, if needed. Today, on the Federal Reserve’s website are the words “The Federal Reserve System, the central bank of the United States, provides the nation with a safer, more flexible and more stable monetary and financial system.” Over the intervening decades, the Federal Reserve’s role in banking and the economy has expanded enormously. Rather than maintain a narrow focus on managing the money supply, the Federal Reserve’s now influences the actions of almost every aspect across today’s economy and financial markets. James Grant, of *Grant’s Interest Rate Observer*, aptly summed up today’s incarnation of the Federal Reserve when he noted during an interview back in 2014:

“The Fed, in substance if not in name, is engaged in a massive experiment in price control. They don’t call it that. But they fix the Fed Funds rate, they manipulate the yield curve… they talk up the stock market. They have their fingers and their thumbs on the scale of finance. To change the metaphor, we all live to a degree in a valuation ‘hall of mirrors.’ Who knows what value is when the Fed fixes the determining interest rate at zero? So, I said ‘experiment in price control’ but there is no real suspense about how price control turns out. It turns out, invariably, badly.”

For years, if not decades, investors have learned to stop worrying about valuations or geopolitical events and just keep buying stocks. The Federal Reserve has done everything in its power to encourage this overconfident mindset, and therein lies the Federal Reserve’s dilemma today. As *The Economist* recently wrote, “Ever since 2008, central banks and regulators have had two goals: to normalize rates and to stop using public money to underwrite private risk-taking. It seems those goals are in tension: the Fed must
raise rates, yet that could trigger instability.” The inflationary consequences of an easy monetary policy for far too long, for the reason of supporting markets, are now forcing central banks to implement policies that will inevitably trigger disruptions in the markets. Investors relentlessly chased markets higher, confident that the Federal Reserve would support their actions. The Federal Reserve operated a monetary policy that was far too accommodative, confident that they could always take remedial action when necessary. The central bank has now painted themselves into the proverbial corner.

Mohamed El-Erian, former CEO of PIMCO and current chief economic adviser at Allianz, explained in a recent podcast the twisted investment logic employed by institutions when operating in an environment influenced by central banks. Today, a typical investment committee in a sophisticated institution will review all the pertinent fundamentals of a potential investment, but the final decision hinges on one critical question, “Who is going to buy after us?” The subsequent buyer will validate the committee’s investment decision, but more importantly, the subsequent buyer provides liquidity if the committee wants to exit their investment. To illustrate this observation, El-Erian states that if someone purchases an apartment, what they really want is ten people bidding for the apartment next door, because the value of their apartment increases. Now imagine that the subsequent buyer is a central bank, the U.S. Federal Reserve, and they have a massive balance sheet coupled with an infinite willingness to use it. Better yet, they are price-insensitive—they buy regardless and in massive size.

If market participants see this behavior month after month, year after year, they will buy ahead of central banks. Whenever a geopolitical shock causes a drop in asset prices, this price-insensitive buyer suddenly appears with unlimited funds. It does not matter if they are only buying government bonds; their indiscriminate actions ripple throughout the entire system. Eventually, markets grow immune to geopolitical risks, or almost any shock for that matter, because investors believe that the Federal Reserve will always play the role of subsequent buyer. This phenomenon is so powerful that a series of acronyms have been created: BTD - Buy the dip, TINA - There Is No Alternative, and FOMO - Fear of Missing Out.

A market where investors have been deeply conditioned to “buy the dip” prevents market clearing prices from reaching historically attractive valuation levels. As market dips have grown smaller in duration and in magnitude, emboldened speculators put more money at risk. U.S. equity markets have returned 20% annually for the last three years despite COVID and a host of geopolitical problems, including the Russian invasion of Ukraine—incredible but understandable and explainable by behavioral conditioning as well as endless liquidity. Perhaps the biggest change with investor behavior is thinking in relative terms rather than in absolute terms. A relative mindset is when one returns home with a dog and proudly declares to the family that you only paid $40,000, but it was a great deal because the cat was selling for $50,000. One continues buying not because there are assets with value, but that value exists only relative to other assets.

At some point, the market pivots from a relative mindset to an absolute mentality. Not unlike a bank panic, these psychology shifts can be violent when they occur and difficult to predict. In a market where stocks are regularly described on CNBC as “plays,” it is apparent that financial markets today have less and less to do with investment, at least not by Benjamin Graham’s definition as “an operation that, upon thorough analysis, promises safety of principal and an adequate return.” While zero interest rates may provide investors “no alternative” but to speculate, Graham emphasized that there are many ways in which speculation can be unintelligent, particularly when one thinks they are investing.

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6 Mohamed El-Erian, Monetary Tightening & the End of the Risk-on Trade (Hidden Forces, February 14, 2022), 10:35.

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Since Russia rolled into Ukraine, retail investors have poured another $12 billion into stock purchases, according to data from Vanda Research. Stocks like DraftKings continue to masquerade as investments but capture the speculator’s imagination. The digital sports entertainment company’s stock has dropped over 70% since its peak in 2021, but the market still values DraftKings at $8.5 billion, even after the company posted an aggregate $2.8 billion net loss over the past two years. Ever the optimists, Wall Street believes the company might finally turn a profit in 2025. Further fueling the animal spirits of speculators, DraftKings CEO Jason Robins took to Twitter to appeal to the FOMO emotion: “If you sold #DKNG today, just be aware that my team and I are on a mission to make you regret that decision more than any other decision you’ve ever made in your life.” Unintelligent speculation continued to be on full display when shares in Amazon.com jumped 8% after the online retail giant announced a 20-for-one stock split, along with a $10 billion stock repurchase—the equivalent to 0.6% of the company’s $1.7 trillion market value.

While central banks suppressed short-term interest rates to near zero, yield-starved investors have chased stocks to valuations now exceeding the 1929 and 2000 peak extremes. Speculation has front-loaded more than a decade of future market gains into today’s elevated stock prices. Those gains are now in the rearview mirror, embedded in valuation multiples that far exceed prior market peaks. The S&P 500 Index’s price-to-sales (P/S) ratio, a reliable valuation measure over time, presently towers far above its prior top during the dotcom technology bubble in the late 1990s. The current level of the P/S ratio suggests that a significant amount of valuation risk will ultimately need to unwind for a normalization to occur.

With history as a guide, a collapse in valuations will return many years of previous stock market gains back to the future. Investors are not entitled to ever-rising valuations. Those who believe otherwise are either ignorant of market history, or much too confident in the current status quo. The record stock prices that investors enjoy today are the product of record valuation multiples on record earnings that embed distorted profit margins inflated by trillions of dollars of deficit spending.

Consumer inflation further complicates the headwinds presented by record valuations. The last time that the consumer price index (CPI), the government’s measure of inflation, stood at 7.9% was back in 1982. However, the federal funds rate (the overnight bank lending rate) in the summer of 1982 stood at 10%. Today, the federal funds target rate is only 0.50%—the Federal Reserve has never fallen further behind the yield curve. The longer the Federal Reserve waits to raise interest rates to a level more appropriate with the current rate of inflation, the more likely it becomes forced to do so in an aggressive manner, one that may shock complacent investors. Whether it was ignorance or overconfidence, enabling the “buy the dip” mantra among investors now hinders the central bank’s ability to tighten financial conditions to levels required to address today’s rate of inflation.
Investors buying the dip today should understand that their persistent bullishness may very well force the Federal Reserve into taking more aggressive action. The graph below (InvesTech Research) shows the paths traversed by the S&P 500 during six previous major bear markets overlaid with the index’s current pullback.\(^7\) While each bear market follows its own path, the graph does provide some perspective on the duration and size of previous bear markets. Based on the price-to-sales ratio, the stock market presently trades at a valuation that is 80% above its historical mean. Therefore, the prudent investor should appreciate the current market landscape within a broader context.

Despite the obscene valuations in the overall market, today there are extraordinary bargains for the thoughtful, contrarian investor. Further, market drawdowns reward the patient, offering opportunities to shop on sale when others panic. While one can only speculate about future market price movements, the investor can remain focused on what they do control—their emotions and their actions. Or as Benjamin Graham said, “Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal.”

With kind regards,

\[\text{Signature}\]

\(\text{ST. JAMES INVESTMENT COMPANY}\)

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\(^7\) InvesTech Research, Volume 22, Issue 3 (March 18, 2022).
St. James Investment Company

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