

The Bittersweet Meeting of Perception and Reality

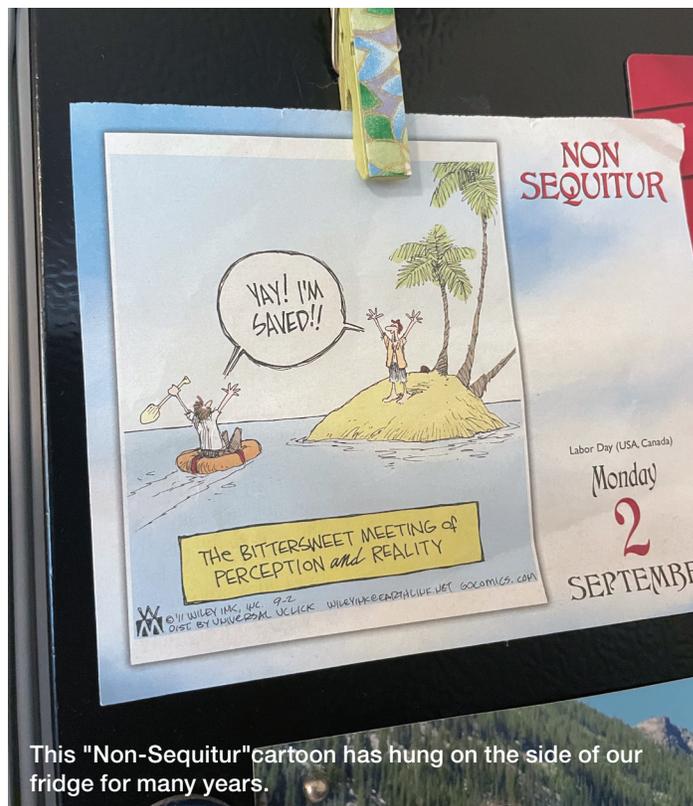
by Jason Hundhausen

“To achieve superior investment results, you have to hold non-consensus views regarding value, and they have to be right. That’s not easy... The good news is that the prevalence of first level thinkers increases the returns available to second level thinkers. To consistently achieve superior investment returns, you must be one of them.”

—Howard Marks, *The Most Important Thing*

This is one of my all-time favorite quotes from Howard Marks. It really marks the crux of what makes this business so challenging: it’s not just about going against the crowd, because sometimes the crowd is right; it’s about finding those times when the crowd is actually wrong, and as Marks says, “That’s not easy.” To me it comes down to a willingness to work hard. In my business, that means a lot of time reading about and studying markets, market history, and listening to what other brilliant people—not just investors—are thinking. The goal is to find pieces of valuable information, not unlike mining out tiny flakes of gold from a mountain of rock, that you can piece together into something of significant value. This process takes time and there’s no way of knowing when the “Aha!” moments will come, but with consistent effort, they do indeed occur.

Over the past year, I’ve had several papers that I’ve read, and interviews that I’ve listened to, that really stood out to me because of a few key thoughts, a few flakes of information gold, they gave me. Since then, they’ve been swirling around in my pan, joining with other pieces, growing to something more significant. I’d like to share a few of these nuggets with you.



This "Non-Sequitur" cartoon has hung on the side of our fridge for many years.

I believe we are witnessing a fundamental shift in society, one that has happened many times before, but not for a long time. For 40 years, capital has been favored over labor, and while this has meant tremendous growth and advancement, it has also led to very high levels of wealth disparity. Today, the tables are turning and capital is ceding power to labor. The pandemic caused a drop in overall demand and supply at its onset, but demand has recovered much more quickly than supply, thus prices have risen and with them the overly optimistic narrative that the inflation will be transitory. The problem is that it hasn't been transitory, and as prices have risen, the demand for higher wages has intensified to the point where workers are walking out. Don't be fooled: it's *not* a shortage of workers, it's a shortage of wages. Employers are responding by raising wages and offering signing and

retention bonuses—some are even offering to pay for college tuition. As labor commands higher wages, these costs will at least partly be passed on to consumers either by raising prices, or by other means, such as reducing portions (“shrinkflation”) reducing staff or reducing business hours. What can’t entirely be passed on to the consumer will be in the form of lower earnings for business owners and shareholders. Of course, once the new wage level is established, it doesn’t matter if supply constraints get cleared, those higher wages—and prices—are here to stay. One of the best leading indicators of inflation is broad money supply growth, so as workers get paid more, inflation pressures rise. The risk that inflation will turn from specter to real-life monster grows the longer it persists. As people expect prices to be higher in the future, they’ll choose to buy sooner (with the raise they got) thereby exacerbating the issue by pushing prices up even more. Rising prices will confirm to everybody that suspicions were correct, and the belief will spread. A contagion will continue until proven otherwise.

Another growing trend contributing to a state of persistent inflation is the movement to reduce global CO2 emissions by “going electric.” The amount of human labor and capital required to replace all our cars, trucks, airplanes, and ships with ones that run on electric motors is creating, and will continue to create, a tremendous demand for copper, lithium, rare earth elements, silica (for microchips), aluminum, and steel, which will drive the prices of those commodities up, contributing to inflation. At the same time we’re busy electrifying our cars, we’re attempting to simultaneously move to inferior sources of electricity, namely wind and solar. Inferior?? Blasphemy! How could I say that? Easy: wind and solar are less dependable because they rely on the sun to be shining and the wind to be blowing. Any farmer knows how difficult it is to be at the mercy of the weather. Wind and solar have a lower Energy Return on Energy Input (EROEI) than natural gas, which means that to produce the same amount of energy, you must build a lot more windfarms or solar panels—processes that require more oil and gas. Wind and solar take up tons of land, and their presence disturbs the plant and animal life that live there, while also creating ongoing conflicts with neighboring communities. And finally, wind and solar have short lifespans and many of the ingredients that go into them are *not* recyclable. That means we not only have to build a lot of them, we have to dispose of, and replace them, more frequently.

There is one source of electricity that trumps all others not only in terms of its EROEI, but also for its lack of CO2 generation, minimal footprint, 24/7 baseload reliability, and 65+ year safety track record: nuclear power. No, uranium is

not an infinite resource and yes, it requires mining to get it (same goes for the materials used to produce windmills and solar panels) but seeing as the amount of energy we can get from uranium fuel is on the order of two or three *million* times that available from an equivalent mass of oil or coal (which itself has a much higher EROEI than wind/solar) you don’t need a lot of uranium to generate a LOT of electricity.

Take, for example, the Diablo Canyon Nuclear Power Plant in California. It’s now been in operation for over 35 years, providing 18.6 billion watt-hours of reliable electricity annually, enough to cover the electricity needs of over 3 million people each year. The entirety of Diablo covers 750 acres, with the power plant taking up a mere 12 acres. Compare this to the largest wind farm in the United States, Alta Wind Energy Center (AWEC) in California, which has a maximum capacity of about 200 million watt-hours annually (93 times less than Diablo) enough to cover the electricity needs of about 32,000 people. AWEC occupies

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around 12,000 acres, which is 1,000 times larger than the Diablo Canyon powerplant. What about solar? The largest solar installation in the United States is Solar Star, also in California. It has over 1.7 million solar panels and occupies an area of around 3,200 acres (266 times larger than the Diablo powerplant), yet Solar Star has a peak capacity of only 579 million watt-hours of electricity annually, or enough to cover the electricity needs of around 94,000 people each year. Oh, and did I mention AWEC and Solar Star only produce power when the wind is blowing or the sun is shining? Again, ask your local farmer about the reliability of these two forces of nature.

Thankfully there are efforts underway all over the world to build new nuclear powerplants and the technology is rapidly evolving. Just recently, 10 EU countries, led by France, petitioned to the European Commission to reclassify

nuclear as a green energy. France, who produces 70% of its electricity from nuclear power, has the lowest energy cost and emits the least CO2 into the atmosphere from energy production in the EU. Critics of nuclear like to point out accidents at Three Mile Island, Chernobyl, and Fukushima, but this is a case where perception and reality diverge. The official death count from the leak at Three Mile Island is zero. For Chernobyl, the official death toll was 30, but this is the subject of much debate. The World Health Organization states a death toll of around 4,000 due to the long-term effects of radiation exposure, none of which pass to offspring. For Fukushima, the death count was zero, although the Japanese government now states that one of the workers exposed to radiation has died of lung cancer. The only deaths that occurred in Fukushima at the time of the event were the result of the tsunami and accidents during forced evacuations, not radiation exposure. I'll also point out that all these reactors were built with what I refer to as "rotary dial telephone" technology. Just think of how safe and reliable a "smartphone" reactor will be!

Such reactors are coming as public sentiment shifts from "Nuclear is bad!" to "Nuclear has proven itself to be incredibly safe and reliable, it takes up hardly any land and, whoa! it produces gobs of electricity without emitting any CO2 either!" I recently heard somebody say that if nuclear power were invented today, it would be hailed as the revolutionary technology that will save the planet. How true this is. Startups like Terrapower and NuScale, as well as major players like GE and Rolls Royce, are all developing Small Modular Reactors (SMRs) which are intended to be easy to manufacture, easy to install (even in remote areas), and incredibly safe due to new designs that don't have any potential to spew toxic radiation into the air should a breach ever occur. There are even designs being proposed for micro modular reactors that require no human presence and run off the waste produced by larger powerplants.

Speaking of waste, this is another aspect that critics of nuclear like to bring up. The fact is, while the spent fuel rods are quite toxic, they're also very easy to store. There's also not that much of it—another benefit of the energy density of nuclear. Since the 1950s, nuclear has supplied the United States with just shy of 20% of all its electricity (that's a lot of electricity) yet all the waste produced would fit in a single football field filled just 60 feet deep. I bet we produce more waste from coal every day!

In the meantime, oil and gas, which are critical to our existence today, are among the most despised companies on the planet. They're also among the least expensive, highest yielding investments available today. Boards on these

companies are being strongly discouraged from developing new wells, but supplies are dropping, and demand is rising. This has and will continue to result in higher gas prices—more inflation! And as I wrote at the beginning, the longer inflation persists, the more it takes hold.

And now, the final reason that I believe inflation is going to be persistent: The Federal Reserve has two mandates. One is to maintain price stability (i.e., prevent things like inflation). The other mandate is to have full employment. The Fed cannot have both—policies that attempt to increase employment are inflationary while policies that attempt to maintain price stability tend to lead to higher unemployment. At this time, the Fed still has the pedal-to-the-metal in terms of stimulating the economy in the hopes that it will lead to lower unemployment. Interest rates are still at 0% and they're adding \$120 billion per month to the balance sheet ("printing money") to keep the stock, bond, and real estate markets propped up. Past attempts to normalize and remove the stimulus resulted in tantrums in the markets and just as quickly as they tried to take the punch bowl away, they had to change course and start pouring in more Everclear to keep the party going!

Herein lies the reason I named this article, "The Bittersweet Meeting of Perception and Reality." A lot is happening concurrently: the perception that because certain investments have performed well the last 40 years they will continue performing well forever is going to be met with the reality that times change, inflation isn't always low, and capital isn't always king; the perception that by building a bunch of windmills and solar panels and driving EVs, we're going to wean ourselves from oil and gas and save the planet is going to be met with the reality that oil and gas are much more prevalent than you think and our dependency on highly efficient sources of electricity will not go away just because we wish it so; the perception that central banks have total control over markets and interest rates is going to be met with the reality that it's markets who price risk and the tools of the central bankers can quickly be rendered ineffective; and the perception that economic prosperity can be created by printing more money is going to be met with the reality that the only way to create prosperity is through hard work, savings, and the prudent use of resources. It's hard, I know. It takes longer and your legs burn more on the hike up the hill than on the sled ride down. But the sooner we accept these realities and learn to live with them, the better, because only then will we be moving in the right direction. ■

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