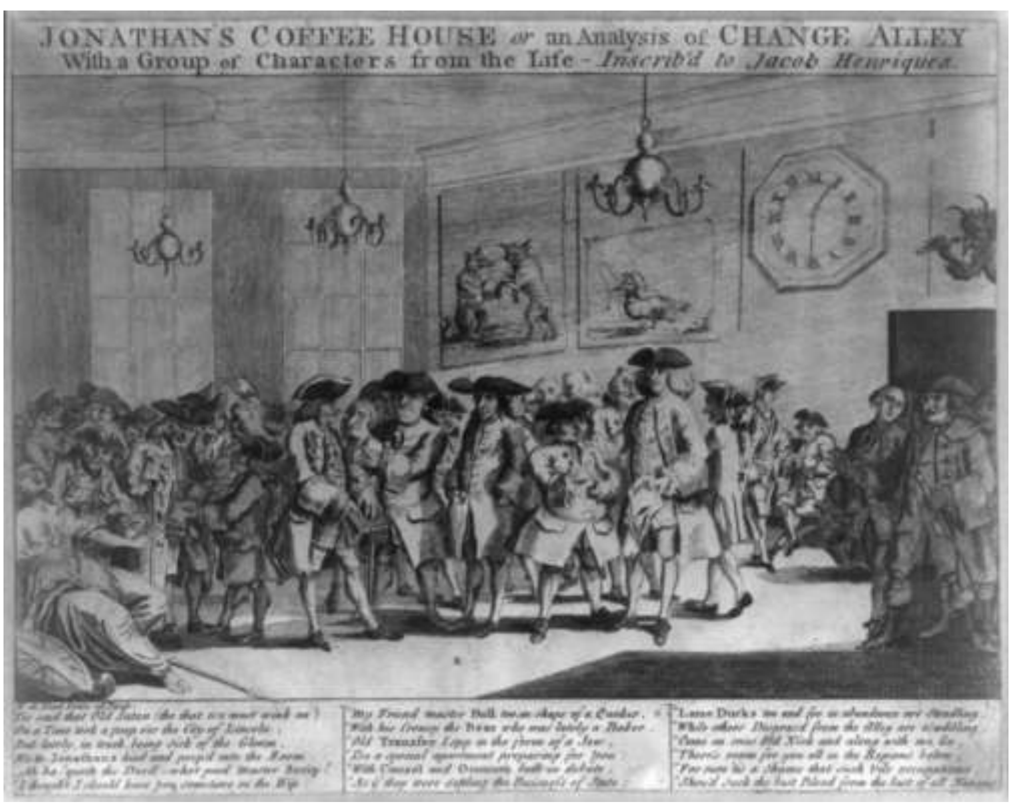
Coffee & Inflation

I had a government professor in college who said there are only two things you really need to know about Western Civilization. “The first is *coffee*, and the second is *inflation*.” Despite the hyperbole, there is actually a bit of truth to that statement.

Coffee was first introduced to Europeans by traders from the Near East around 1615. Shortly thereafter, a number of notable leaps were made including the advent of the microscope, telescope, calculus, universal gravitation and even calculating machines. While we certainly can’t say all this was directly related to the introduction of coffee, the story gets more interesting very quickly.

It also was the period when the first ever public stock corporation was founded—the Dutch East India Company. Pieter Van Dan Broeck, a famous Dutch East India trader, first tried coffee on a visit to Mocha (Yemen) and quickly set his sights on gaining a monopoly for his firm. Not long after, the Company made the first ever "foreign direct investment," by purchasing the island of Manhattan from the Lenape Native American tribe in 1626. It only took until 1668 for their new product, coffee, to overcome beer as the preferred breakfast beverage of New Yorkers. The Hudson River delta would never be the same again. Coffee was the ascendant beverage, revving up city entrepreneurs and helping New York on its path towards becoming a leading global business center.

Many historians will say flatly that modern capitalism was invented during this period of the "Dutch Miracle." Even the London Stock Exchange (LSE), which was founded in Jonathan's Coffee House in 1680, was tied to the broader coffee story. Its brokers had arrived after they were ejected from the Royal Exchange for "rowdiness." Predictably, this Coffee House cum Exchange later became the epicenter of the infamous "South Seas Bubble," when coffee-rattled speculators caused the first major international financial crisis by building up fanciful expectations about the future of Latin American trade.



Jonathan's Coffee House, London, 1763. Artist: H.O. Neal

(Note the bull and bear in the image on the wall, as well as the devil with the lute on the right hand border.)

This really isn't too surprising. Anyone who drinks coffee knows intuitively the "jazz" it brings on is not a force to be trifled with. Caffeine remains the only drug accepted widely in the workplace, and bought regularly for workers by employers, ostensibly to enhance productivity.

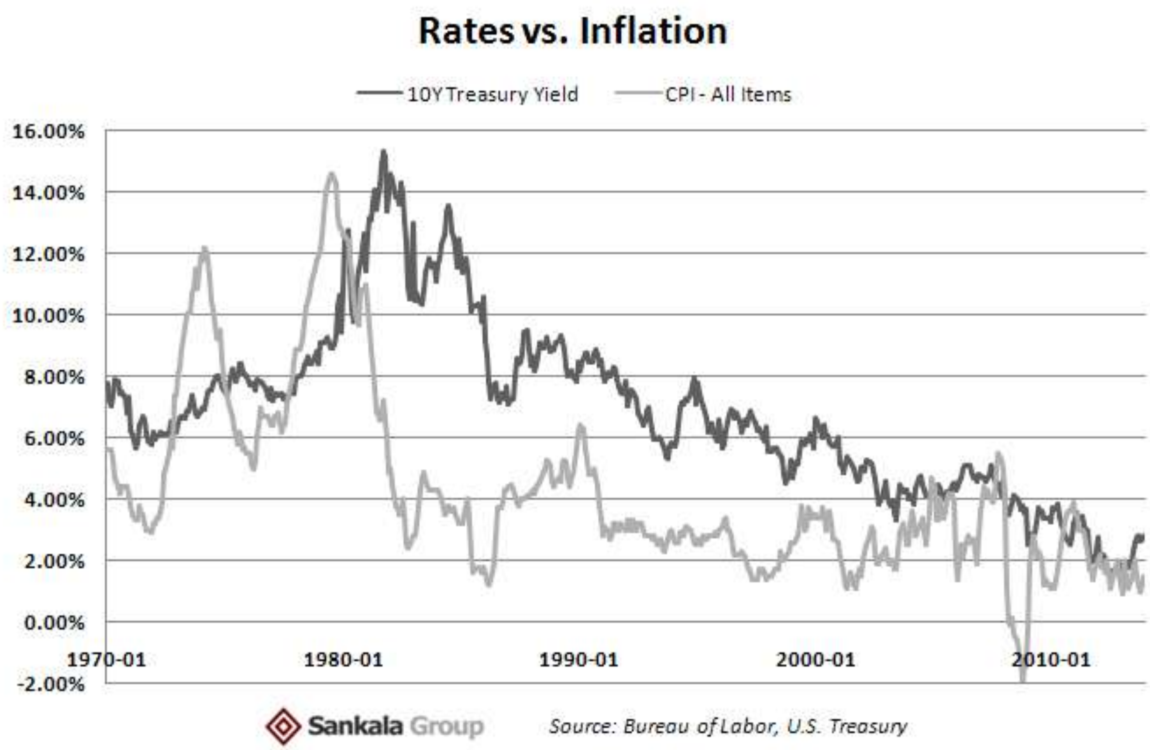
More seriously, there is only one force that gets business people out of bed more quickly than coffee. That force is *inflation.* Broadly speaking, inflation is the process by which money becomes less valuable year after year. Controlled and manipulated by central banks, inflation is not some distant theoretical principle— it is the palpable anxiety that prevents us from putting our savings under the mattress to sit idly. Our knowledge that our savings will buy less than it did the year before is an economic drug of the highest order. It creates significant urgency to deal, trade and invest *today*. That, in turn, increases the velocity of money in the economy and drives growth.

The anxiety of inflation, and specifically the 2% annualized level of anxiety deemed livable by the Federal Reserve, is now a cornerstone of Western-style capitalism. It is the fuel that keeps numbers constantly moving up and away from people, such that they will take up chase like children running after a helium balloon.

As investors, we need to grab the string on that balloon as deftly and authoritatively as possible. It might be a child's game, but we are forced by central bankers to play it in a very adult manner. Any investment we make should have high probabilities of positive returns after accounting for inflation. In economic speak, we call these "real" returns. Real in this case simply means "after inflation."

In previous letters I introduced some ideas related to Massachusetts, Colorado and New York municipal bonds. These bonds are attractive because the interest earned on them is exempt from most Federal and State taxes, and for certain investors can provide significantly better after-tax results. Our positions in these bonds have worked well over recent quarters, not only paying us tax-free interest, but also accruing capital gains. In fact, municipal bonds have been on a record streak, beating the returns on similar dated Treasuries for 10 months running. This strong performance is related to short supply of the bonds themselves, and increasing expectations for higher tax rates in the future. Higher tax rates have the potential to make these bond's tax-exempt income streams even more valuable.

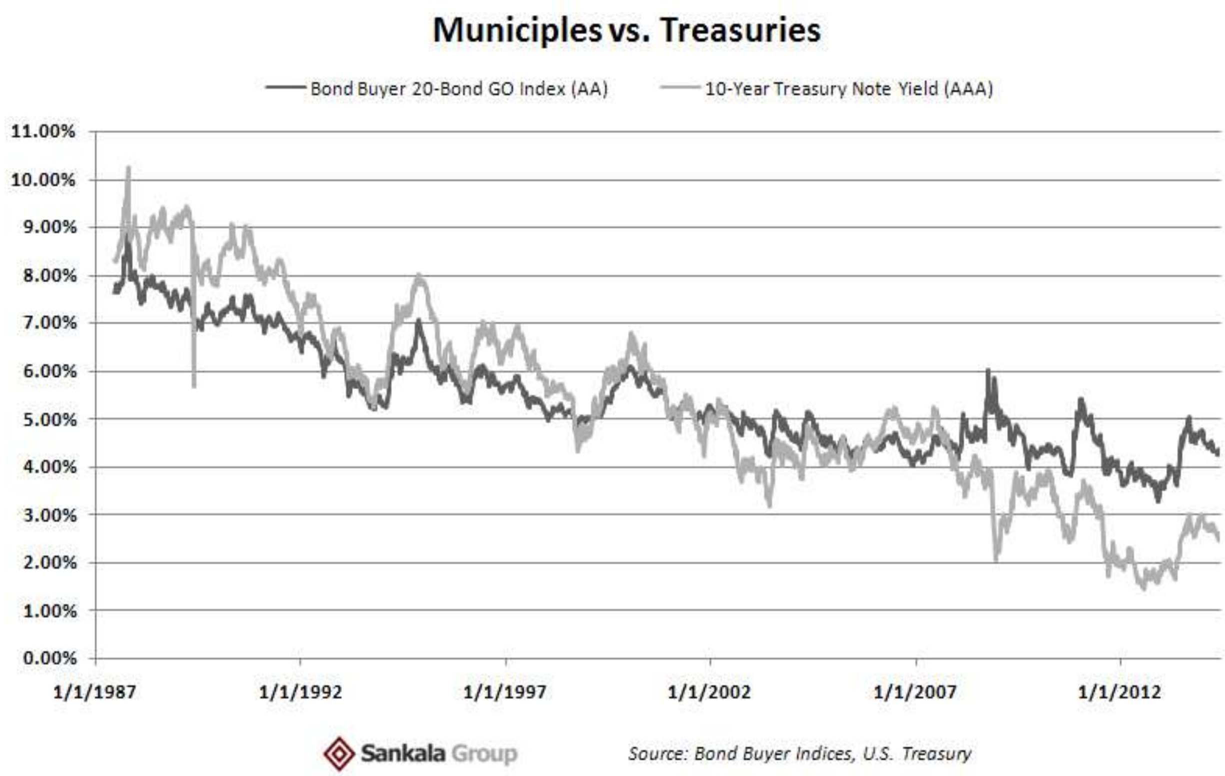
So we are now faced with the question of what to do next with these bonds. Do we invest more at current interest rates, hold what we have, or sell? To answer that question we need to look at the history of inflation more generally:



The plot above shows the “spread” between inflation and Treasury interest rates. This spread represents *real* rates of return that buyers of 10 year Treasuries received at various points in time. In the early 80’s investor’s could have bought Treasuries to yield 14% interest, while inflation ran around 4%, giving them *real* returns of ~10%. On the other hand, buyers in 2010 could have bought Treasuries such that inflation was equal to /or greater than the interest rate, giving them zero or negative *real* returns. We can safely generalize based on this data that bond investors are getting a worse deal relative to inflation than they have at pretty much anytime in the last 30 years.

You might also notice the spread has actually widened back out in recent quarters, such that positive *real* returns do again exist, despite being quite meager. Keep in mind that all this analysis relies on us trusting government inflation numbers. We are not liable to do that because we understand the conflicts of interest involved in governments reporting their own inflation statistics. We are far better off triangulating with a disinterested third-party’s view on inflation. The best source I’ve found is called the [*Billion Prices Project*] at MIT, which uses internet scraping technology to monitor prices in the economy rather than the more opaque methods used by the Bureau of Labor. What we find is that the government appears to have been understating inflation by about 0.5% annually recently. That means that the spread seen on this chart in the last few quarters is likely *worse* than it appears. The conclusion here must be that bonds remain a decidedly risky asset class, with lots of potential to fail our positive *real* returns test.

Next we should look at the specifics of municipal bonds vs. Treasury bonds:



As you can see, interest rates on municipals have been more attractive than Treasuries since 2008. Perhaps this is due to the impact of the Federal Reserve's bond buying programs which have forced Treasury yields lower, while leaving municipals less impacted. Given the tax-exemptions involved, municipals are currently offering quite a bit more return for us, while only stepping our credit quality down one or two steps from the AAA standard. Just like the market, we also see tax rates as likely to rise in coming years, and so agree that these exemptions and the underlying bonds are also getting more valuable.

This leaves us with a pretty clear conclusion regarding our fixed-income strategy. We will remain underweight fixed-income in general due to the bad state of rates relative to inflation, but continue to bias towards municipal bonds over Treasuries in the fixed-income we do own.

From the standpoint of my own business, this creates a unique opportunity. For those clients that can benefit from these tax exemptions (which is the majority,) I will increasingly be helping them locate attractive municipal bonds, tailored directly to their needs and local interests. One of the great advantages of investing in your own state's municipal debt is that your investment is going to work in your own community, supporting the construction and upkeep of infrastructure you actually use.

Furthermore, we won't worry about discussions in Washington about reducing or cutting these tax exemptions for municipal bonds. After examining a number of the likely directions for these reforms, they all point to outcomes where any changes will affect only new municipal bond issues, making them less attractive, while handing current owners a good probability of windfall gains as supply of the grandfathered exempt bonds is reduced or cut off entirely.

To wrap up, I'd like to offer one final insight linking coffee and inflation together. A friend recently suggested I switch my coffee brand from Starbucks to Peet's on account of the fact that Peet's is so incredibly powerful he could use 33% less grounds each day to get the same fix. My real life findings corroborate this view. I'm definitely as jazzed as I want to be on less coffee these days.

Given that Starbucks and Peet's typically cost $10.99 per pound at retail, this idea has the potential to save me about $94 per year on my coffee spend as an individual 2 cup a day drinker going through 1 lb every 2 weeks. Savings could be quite a bit higher for families or more chronic users! I suggest you consider taking this advice as well, and then use the savings to buy an hour or two of consultation on the details of your local municipal bond environment. Given the tax deductibility of my services, you will create enough residual value to buy about five Starbucks lattes in the actual coffee shop. Just imagine how enjoyable it will be to sit down, open up your municipal bond portfolio, and bask in having Western-style capitalism licked.

You're now drinking coffee you bought with financial engineering, and simultaneously tackling inflation while your money goes to work in your very own community!

Best,

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