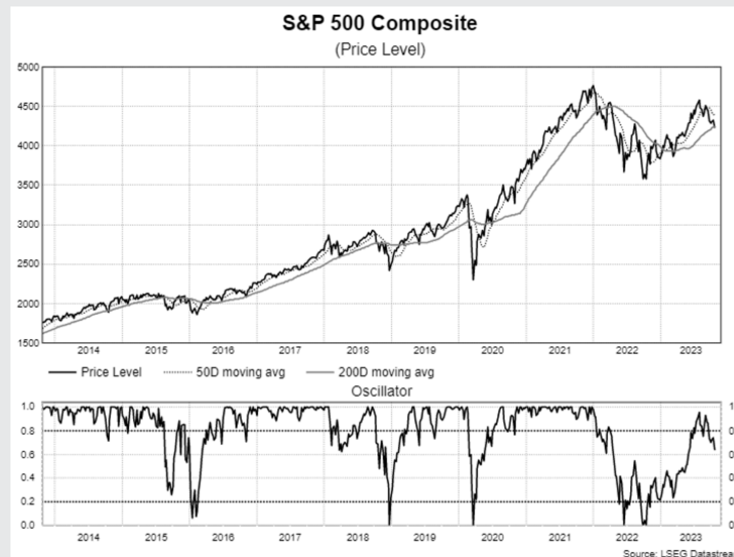
WILDE CAPITAL MANAGEMENT

Newsletter and Capital Markets Review

Q3 2023

Rise of the robots? Maybe not quite yet.

US equities, when measured by the S&P 500 index, are trading around a key long-term support level, the 200-day moving average. This is after falling some 7.5% since the index high on July 31st. The question on the table for investors is whether this is a pause or even buying opportunity, or if there is further downside. One significant concern is that US stocks, as of the end of the third quarter of 2023, have thus far failed to reclaim the all-time highs from the beginning of 2022. The key theme driving the broad stock market higher over the course of the past year has been the technology sector, particularly those stocks leveraged (or at least what investors convinced themselves were leveraged) to the artificial intelligence theme. That trend is likely to play out favorably over the long term but storm clouds have been forming over the past several months. AI has been the new "it girl" in the market picking up where cannabis, crypto and blockchain left off, and as with so many prior concentrated thematic rallies like the Dot Com boom, after the first fortunes are made and then lost, it takes a while for the adults to bring order to the market and look for durable evidence of long term value creation and not just the magical fairy-dust trails of tech unicorns leaping through the air.



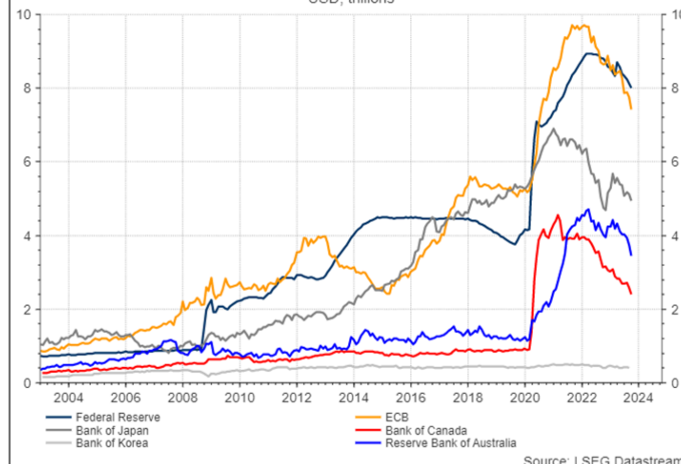
But, the good news is that, underneath the mild hysteria of AI, there have been broader positive signals that companies across industries and sectors are doing reasonably well. Fundamentally, forward earnings expectations for the S&P 500, according to IBES, continue to maintain positive upward momentum. That may be good news showing resilience in the face of rising interest rates, or it may be a reason to worry that the effects of those rates haven't filtered into earnings and fully into trading multiples (yet).

Long-term interest rates in the US have risen significantly off a very low base over the course of this year and have sharply risen since the stock market peak in July. There are several factors driving interest rates higher across the yield curve as inflation remains elevated and still above the US Federal Reserve's target levels. Adding to the mix is record high US Treasury debt issuance related to persistent federal deficit spending. The US Treasury announced that the federal deficit topped $1.7 trillion, a massive 23% increase from fiscal year 2022. A toxic mix of lower tax receipts, higher Social Security and Medicare outlays, and ballooning Federal debt interest costs were the main drivers of the increasing shortfall. Social Security and Medicare benefits are adjusted for inflation which, in effect, self-perpetuates budgetary pressures. It is hard to envision improvement in any much less all of these areas without significant policy adjustments, which are unlikely to occur due to political divisiveness in Washington, DC on a path out, but seeming lockstep on pushing the nation deeper in.

Market Review [cont'd]

In addition to the strained fiscal conditions facing the country, US monetary policy continues to be less and less accommodative. Beyond the elevated Effective Fed policy rate, albeit steady at 5.33% since the end of July, the Fed balance sheet continues to shrink. And, balance sheet contraction is occurring globally as nearly all major central banks are acting in unison. Coordinated quantitative easing since the Financial Crisis and the Pandemic was effective in supporting the global economy but the effects of quantitative tightening are unknown. Perhaps central banks acting in concert to reduce balance sheets will avoid the classic implications of aggressive money printing (hyper inflation) in any country or currency bloc.

The Broad US Money Supply M2 has also contracted 4.4% or nearly a trillion dollars since peaking in July 2022, which is yet another major headwind for risk assets. Normally the money supply grows above the rate of nominal GDP growth, historically north of 6%. This contraction may be the result of adjusting to the explosive Pandemic-related growth in M2 in 2020-22. One influential school of thought is that there is a time-dislocated but still strong relationship between money supply and inflation, and that the burst of Pandemic M2 had a lot to do with the inflation surge, and therefore the only path off the inflationary mountain is to withdraw some of that money supply to bring the economy back on trend, with all the pain and damage that potentially entails. Early predictions were that this retracement of money supply would cost jobs and drag down markets, but so far employment has remained extraordinarily robust and while equity markets have not regained their 2022 highs, performance has been decent. We are still in the middle of this story and there are a lot of complicating factors as discussed in the following risk section of our newsletter, but in the face of those challenges the investment landscape has been not entirely inhospitable.



Risk Review

We are continuing with our "dirty dozen" factors that continue to challenge the real economy as well as the capital markets. Some areas have evolved slightly, and we are mindful that markets taken as a whole have been doing a supremely good job of shrugging off most of these challenges so far in 2023.

Inflation – Energy, Commodities, Housing

Even with signs of moderation, inflation is locked in and it is global. When we first started talking about inflation during the pandemic, we saw it as localized around specific circumstances related to the pandemic from the now almost-cliché supply chain disruptions to worker shortages in service-related businesses to dislocations in very specific industries like the "crack spread" between lumber at the stump vs. milled and ready for use. These economic kinks did not have an opportunity to work themselves out before trillions of dollars of stimulus and new money were poured into the economy driving increased appetite, and as a result there is demand and price pressure exceeding a still-disrupted global economy's ability to satisfy from microchips to chicken. Add in the effect of the Russia-Ukraine war and related sanctions regime on gas, oil, grains, steel, etc. and we anticipate some extended inflationary pain until global economies can work off the pandemic spending that compounded latent problems with overly accommodative policy since the Financial Crisis. Supply chain issues are not what they were earlier in the pandemic cycle, but consumer price inflation is now baked in. We have seen energy markets retreat and then spike, and housing is heading for a historically large setback while automobile and other inventories build, so watch this space.

Reduction in monetary expansion

The proverbial punchbowl has finally been taken away. Central banks are printing less, quantitative easing is giving way to neutrality or even quantitative tightening, and policy rates are rising. There is less money (M2) being created and the cost to borrow it is going up. Even though it can be credibly argued that central banks, and in particular the Federal Reserve, remained expansionary for too long and this is a healthy and necessary change, it is still a regime change that has consequences after a decade-and-a-half going the other direction, and the steepness of the rate of change is inflicting meaningful short-term pain, particularly for those closest to the economic fringe. More ideal would have been the Fed moving much sooner and more incrementally instead of having to slam hard on the proverbial brakes and bang everyone's foreheads on the dashboard. Or, as Professor Steve Hanke of Johns Hopkins University has repeatedly pointed out, if those with control of the presses had printed less new money from the beginning of this crisis, inflation would not now be the entrenched problem it is with the only real solution being an undershoot on money creation to bring us back to normal.

Rising interest rates

Which brings us to rates more specifically. While we are, to put further mileage on a tired cliché, closer to the end than the beginning, to put the clamps on inflation the Fed and other central banks will continue to withdraw stimulus and raise rates. There is certainly a benefit to savers that, for the first time in nearly a generation, savings accounts, time deposits, CDs and money markets are paying decent rates rather than just providing stability and safekeeping. But, inflation is still exceeding those rates in many areas of the economy, particularly basic essentials, so real returns are still negative. At the same time, the cost of capital to individuals, businesses and governments is rising which will make debt service more expensive and slow new borrowing. That is the intended effect, slowing economic activity and cooling inflation. But, higher rates will filter down through the economy and make goods and services more expensive and put housing further out of reach for many families while making variable rate debt like credit cards more expensive and more likely to tip borrowers into default or bankruptcy. For those with greater wealth security, the idea of bonds as an investable safe harbor is sorely challenged and will force a change in ownership patterns. Collective vehicles like mutual funds and exchange traded funds investing in bonds will be treated as riskier because of price volatility when not holding individual issues inside the funds to maturity.

Risk Review [cont'd]

US High Yield

Low-quality debt (junk) issuers have enjoyed an extended period since 2017 of economic advantage where it has been fairly inexpensive to borrow as the market has not demanded a significant risk premium for lower-rated issuance. All of the many strains on economies and markets are forcing a re-rating of junk bonds and a return to a historical spread over investment grade corporate or Treasury bonds to pay for the additional risk. This will become more of a self-fulfilling prophecy as rates continue to climb and it becomes harder for risky enterprises to borrow at interest rates they can sustain without default. In some cases the environment will force companies to clean up their balance sheets to lower their cost of borrowing, and in other cases Warren Buffett's maxim "It's only when the tide goes out that you know who's been swimming naked" will be in effect.

Full, although declining, equity market valuations

As noted elsewhere in this newsletter, valuations are definitely below where they were when we described them as "full" previously, but conditions have also changed (see the 11 other risks) and based on today's macro outlook even priced at a lower valuation equities may still be characterized as close to full. We believe business and market conditions are such that the market could reprice and reset a full and fair multiple as much as 25% lower than present levels, although this risk appears to be continuing to recede as markets defy expectations and fundamentals to climb higher.

Corporate earnings still growing but the pace is slowing

Corporations have been able to capitalize on various price dislocations from food and basic materials to oil, airlines and automobiles to keep the good times rolling even into the current challenging market conditions. But, 15+ years of cheap capital are over with easy Fed policy giving way to QT and rising rates, which combines with rising wages, supply chain costs and less liquidity for consumers to put margins under pressure. Companies, particularly in areas like food and other consumables, have had the ability to increase prices to maintain or expand margins in the last several quarters, but this period is drawing to a close. Quality will certainly matter more both in terms of how capital is obtained and deployed and how crisp business execution is in order to sustain and even grow earnings.

Negative real wage growth

Wages are rising which is a hard-won victory, but inflation is rising and in some spaces rising faster, erasing those gains in real terms at the kitchen table. That reality reverberates through the economy as purchasing power for those most likely to spend their paychecks – the middle class and the working poor – declines.

Consumer sentiment

Although slightly improved from a historic low in July of 2022 (U. Of Michigan Consumer Sentiment Index), overall declining sentiment tracks with inflation overriding wage gains. The various components of inflation as experienced by consumers further aggravates those negative sentiments. Even if a consumer commits personal capital to make purchases, goods have been harder to get and pricing power is currently vested with merchants over consumers, leaving a palpably bitter taste. This is starting to moderate in areas like the automobile supply where tight supplies opened the door to almost predatory pricing on dealer lots as even very ordinary and utilitarian vehicles were being sold for thousands over MSRP. This kind of disempowerment of consumers has knock-on effects and is now coming back around in the next stage of the economic cycle as the proverbial shoe ends up on the other foot as supply chains catch up and the power is vested back in the hands of those same consumers.

Supply chain issues

We have seen graphic examples of how interdependent world economies and supply chains are and how fragile they were with just-in-time inventory management. While investors have extolled just-in-time inventory since Toyota popularized it, it introduced an inelasticity into global supply chains that was not capable of absorbing the blow of COVID. We liken this to everyone on the highway cruising at 70 MPH riding bumber-to-bumper and doorhandle-to-doorhandle. It works fine until somebody swerves or stamps on their brakes. This was further exacerbated by climate-related issues, international conflict, localized issues like the lockdowns in China. There has also been evidence of invented distortions and profiteering in a number of areas that is still working its way out of the system.

Risk Review [cont'd]

The results were issues such as a microchip shortage affecting the ability of factories to finish automobiles for delivery. Many of these challenges are easing and even reversing, such as in Ukraine and Eastern Europe where food shortages have turned into food surpluses extreme enough that countries like Poland are essentially embargoing Ukrainian goods so as not to destroy their domestic agmarket. In the meantime, as investors and market watchers, we are looking at the confluence of business practices that are not sustainable, resilient or adaptive and externalities like global health, territorial conflict and climate change which can and will disrupt businesses and markets again.

Slowing home sales

As we have been cautioning for some time, we see housing as ripe for a significant correction, compounded by the current state of affairs. This market cycle is unlike any previous one because we have what we would characterize as an unnatural market participant – private equity firms – not present in prior cycles. Where home ownership was concerned, financial products related to homes were largely derivatives of the actual dwelling, like mortgage portfolios. PE firms went a step further and rather than accepting the dwelling as collateral for a mortgage, they purchased the actual home, effectively "productizing" it. Now you have institutional-scale market players that are strictly governed by the economics of the assets (homes), and not the intangible value an individual or family derives. This introduces new opposing forces because an institutional owner is more likely to want to sell the asset when the market is under stress because of economic conditions, while a traditional homeowner is more likely to hunker down in place and use the home as an anchor of stability. At the same time, the pandemic accelerated what we see as five to ten years of outward migration by Millennials and others from the urban cores to suburbia into the two years of the pandemic, which converged with historically low mortgage rates to drive a bubble in home prices. While we do not expect the same kind of damage in housing as was left in the wake of the Financial Crisis, we anticipate rising rates and an overshoot on valuation will destroy value. Countering that, we observe homeowners frozen in place because rising rates make it very unappealing to obtain a new mortgage for a different home because the exact same mortgage amount would be substantially more expensive to finance in a new loan. This has kept a lid on supply and helped prevent more widespread damage to residential real estate. So far.

Waning fiscal stimulus

"Waning" might be too passive a term to describe conditions. The US Congress is done with major spending legislation for the foreseeable future, particularly with the House of Representatives in new hands for the current session. The Federal Reserve has been aggressively drawing down QE and raising rates to reel in inflation and move us back to some semblance of a historical normal, and only now starting to level off toward perhaps a new equillibrium. Easy money for financial institutions, corporations, mortgagees, consumer borrowers and the US Government, States and municipalities is over. This regime change which combines the end of at least 15 years of stimulative support and more than 40 years of declining rates will change the growth dynamics in capital markets for the foreseeable future.

Geopolitical flashpoints

There are too many to count, but the Russia-Ukraine conflict is a leading example of the risks. As we have written previously, neither country is particularly large in terms of GDP when compared to greater Europe, North America, Japan or China. But, cutting off "Europe's breadbasket" and disrupting steel and other industrial materials flowing from Ukraine to Europe and beyond, combined with the consequences of the global sanctions regime against Russia, which is basically a petrostate, turbocharged inflation in food and fuel globally. China of course is still for the most part the world's manufacturing floor and their flexing over Hong Kong and Taiwan, both significant global economic engines in their own rights, poses military as well as economic risks globally. Looking to the future China's aggressive moves in Africa to secure access to natural resources may become the source of future contests as well. More regionalized but hardly less concerning, a reorienting of power dynamics in the Korean peninsula could change South Korea's (#13 largest economy by nominal GDP) relationship with the West at the same time North Korea rattles its sabre and threatens Japan (#3 behind the US and China).

ESG Considerations

What happens after remediation and mitigation fail?

We have reached a maturation point for ESG in listed markets where a basic framework for inclusion of environmental, social and governance considerations has been widely adopted. The focus has broadly fallen out into two general categories – risks to be avoided and opportunities to be seized. Risks run the gamut from climate to pollution to human rights to diversity and access. Either avoid the worst performers or attempt to lean into investments with the lowest risk quotients in this regard.

Opportunities can be found in numerous areas from new tech to basic materials that are part of building a clean and green and just economy. In many permutations of the strategies that investigate and incorporate these risks and/or opportunities, there is a threshold expectation of performance, a purity test of sorts but one that is rooted in an optimistic view of the future where the many challenges expressed in the UN Sustainable Development Goals are addressable and solutions achievable. Even in the most cynical implementation of ESG, integrating these factors into the evaluation of any company, "clean" or "dirty", that optimistic stance holds and it seems like too much of a capitulation to say something is so broken that the thinking has to shift from how to avert an outcome to how to deal with the inevitable.

This type of thinking, a focus on resiliency and adaptation, is not absent from ESG investing, but it is often relegated to a secondary or tertiary consideration, part of a broader thesis rather than being the thesis itself.

Let's start by having a working definition of resiliency (and adaptation):

The ability to withstand and adjust, and even thrive, when faced with systemic physical challenges which may not themselves be addressable or mitigable.

- *Could be an issue of time*
- *Could be an issue of scope/reach*
- *Could be an issue of available power or resources*
- *The answer is not to throw hands in the air and give up*

Since ESG (SRI at the time) more or less began in the stock market, we will start there. There seem to be two ways to address resiliency when looking at companies. Companies can be in the business of resiliency – technology, materials, innovation, etc. that make the world more resilient, such as better building materials to withstand extreme storms or wildfire. Companies can also be working on being more resilient – reordering their businesses, whatever that might be, to withstand external and often unmanaged challenges.

It requires a shift in mindset. Believing in and then investing in the statistical likelihood that we will surpass the 1.5 degree threshold for irreversible climate change is not capitulating to that outcome. It is not saying it is no longer a priority to avoid that outcome through remediation and mitigation efforts. However, it is saying, seen through a very classical risk management lens, that you are not a good steward of capital if you simply refuse to accept the high probability of that adverse outcome and then managing to that case. You don't purchase fire insurance and pay taxes for a fire department and fire hydrants because your house is on fire. You do it because your house is flammable. And in the case of climate change, there's an arsonist running around the neighborhood with an increasingly large book of matches.

Continuing the house fire analogy, companies make fire resistant materials, fire alarms, fire suppression systems, fire trucks, fire hoses, fireproof suits for the emergency workers, and so on, and profit from those businesses because people want to be protected from the non-zero risk of fire. In the same way, companies can build product and service lines or entire businesses around individuals, families, institutions, businesses, communities, municipalities, even whole countries to better situate them to face various increasing risks, whether that is to resist them entirely or recover quickly from what may come.

ESG Considerations [cont'd]

It isn't just about resilient and adaptive companies. Physical assets like real estate directly reflect that house-on-fire analogy. A beachfront apartment building at risk of inundation from rising sea level or being lashed by increasingly violent tropical storms presents risks to its occupants as well as its owners, bankers and insurers. Making that building more resilient to the type and magnitude of threats being thrown at it makes it safer, more reliable, and in the long run more valuable. An astute portfolio investor will be thinking about these rising risks to residential and commercial real estate and infrastructure when considering the suitability of the investment as well as what to expect in a return commensurate with the real challenges posed as well as the steps taken to manage exposed vulnerabilities.

The same can be said for communities as well. Extreme weather can overwhelm municipal resources and infrastructure that are both the assets and the life blood of communities. Roads buckling in extreme heat, sewerage and storm water systems overwhelmed during storms, depleting drinkable water from aquifers and reservoirs, are all examples of challenges that can be predicted and modeled and then managed, usually at much less consequence and cost than waiting for a worst-case outcome and then paying for the aftermath. Better community resilience and adaptation may cost more up front but likely reduces lifetime costs for these assets because obtaining municipal debt financing may be cheaper, as would insurance, costs of maintenance, and cost of replacement/mean time to failure.

All of this naturally leads to the question "What about insurance?" That is probably the most obvious pressure point where resiliency and adaptation interface with markets and finance. Assets that are increasingly at risk from external threats become increasingly expensive to insure until eventually they are entirely uninsurable, as homeowners in California are finding in wildfire country and in Florida are finding in hurricane country. Reinforcing assets against those threats serves as its own insurance and makes them more attractive to underwrite, whether it is property and casualty insurance against physical assets or portfolio insurance against investments and loans.

A pragmatic investment discipline incorporating assessments of asset resiliency based on ESG criteria into how capital is allocated should lead to better portfolio outcomes and fewer "Black Swan" events by discounting in and then managing the likely arrival of those events. A hurricane, flood, wildfire or drought may be considered an externality, even a low-probability or at least low-frequency externality, but they are increasingly present in the environmental systems in which businesses and communities exist. Placing an emphasis on resiliency and adaptation in portfolio decisions is like paying for the fire department. It costs money that could be deployed elsewhere. You hope you never need them, but if you do, at least they are a 911 call away. It is a necessary feature of a truly comprehensive approach to any portfolio, particularly one espousing ESG principles.

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