Normalization and the Clearing of QE Era Excesses

The Thinking Man

May 2022 | Series #93

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- QE era excesses in SPACs, EV's, crypto's, and Stay @ Home stocks have cleared, creating a more fertile investment landscape for mid-term oriented investors
- An aggressive move in U.S. treasuries have made low duration, high quality corporate fixed income attractive again
- Though recessionary fears are rightfully elevated, the American consumer and corporate earnings remain strong
- The war in Ukraine and Chinese lockdowns remain the most significant near-term sources of uncertainty
- We continue to favor value sectors with inflationary and geopolitical tailwinds (energy and materials), defensive healthcare, regional banks, and legacy / profitable technology

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

Capital markets are a pendulum that swing back and forth between the two poles of expectation and reality. Sometimes what matters to investors is the future narrative, other times what matters is the fundamental reality: the plain facts of what a business is *today*.

Since the outbreak of the Covid pandemic (and arguably since the financial crisis of '08-'09) capital markets have swung to the pole of the "narrative": not what something *is*, but what something *can be*. This willingness to be optimistic is not only a reflection of human psychology, but also of economic fact – when interest rates are low and the monetary base is large and growing, or simply put, *when there is a lot of free money,* the bar for what counts as "an attractive business model" is exceptionally low.

The reality is that money cannot be free forever, and therefore not every business or idea can be attractive forever. If everyone has more and more free money, then the cost of everything increases to the point where having more money doesn't actually allow you to buy more things. In order to protect the consumer, central banks raise interest rates, and unproven businesses are suddenly faced with higher costs of capital and investor skepticism. Distant cash flows get discounted at higher rates, and long-term growth aspirations are replaced with near-term reality. Additionally, since U.S. risk-free rates serve as the reference rate for most global assets, in periods of aggressive price swings, historical asset correlations tend to fall apart. Add to that external supply shocks (i.e. a pandemic, a war, a decoupling of trade relations, or all of the above), and the result is exactly our present situation. Everything from food to asset prices to energy becomes too expensive to bear, and people are left wondering, *what now?*

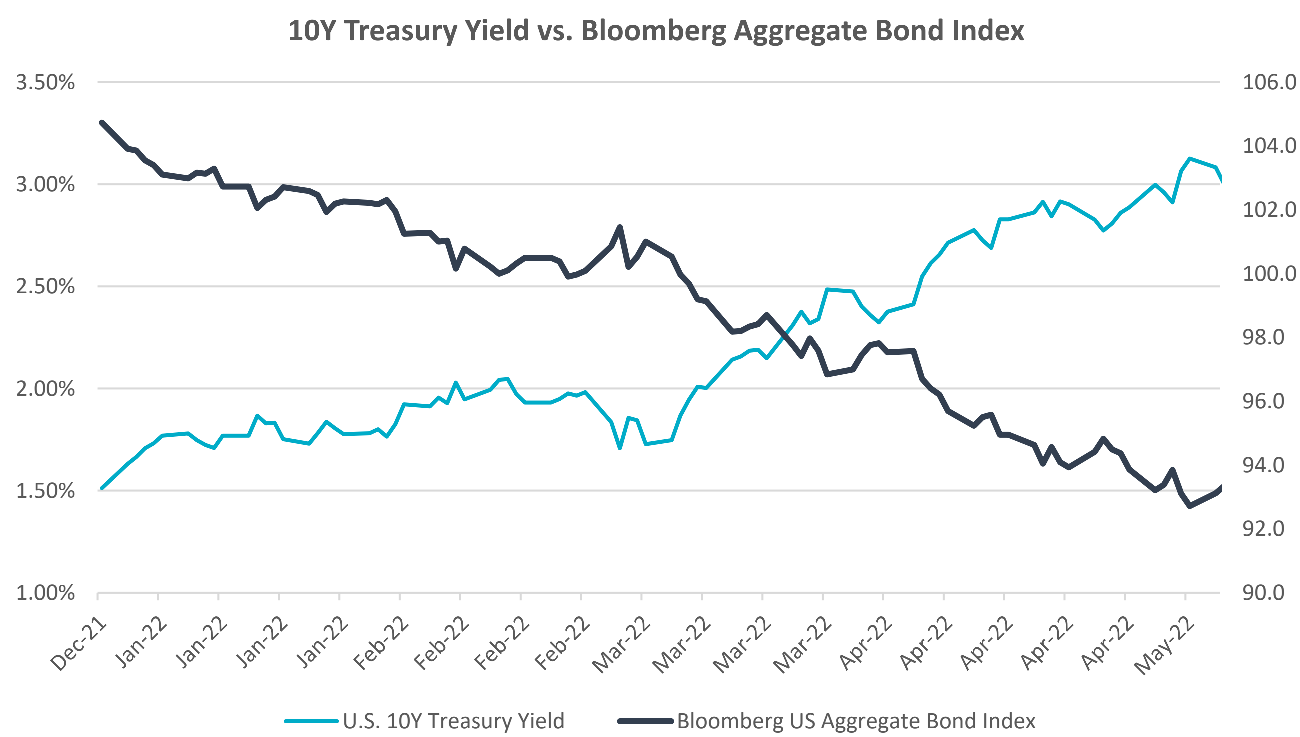
The answer to that question is the title of this Thinking Man, *Normalization and the Clearing of QE Era Excesses*: the pendulum has swung back to the pole of reality as the QE era playbook of "buy the dip" and "growth over value," is now "sell the rally" and "value over growth." Year-to-date we have experienced an unprecedented move in government yields and a swift correction in the more speculative and growth-oriented pockets of the market (i.e. SPACs, EV's, ARKK constituents, meme stocks, and everything crypto/NFT-related). The question now is where do we go from here, and what can investors do to mitigate their risks in a rollercoaster market?

Bond Market: Worst Market Since 1842

Here are some credit market stats for context:

- Over the course of ~4 months, the 10 year U.S. Treasury yield has doubled from ~1.50% to ~3.00%
- Long term treasury bonds are down more than 18% through April 30th, surpassing the previous record of a ~17% drawdown in the 12 months ending in March 1980
- The broader bond market has performed worse so far in 2022 than in any full year since 1792 with the exception of one calendar year (1842)
- U.S. aggregate high-yield spreads have widened from a pandemic low of ~250bps to ~440bps

What is the cause of this aggressive upward move in yields? An unexpectedly swift reversal in U.S. and global monetary policy. We should remember that the QE era formally ended only in February 2022 (when the Fed was still buying most of the issuance of U.S. Treasuries, TIPS, and MBS). In the span of a few weeks, the Fed abandoned its "transitory" inflation narrative, essentially conceding that it had been wrong to keep the monetary taps open for as long as it did. Nowhere was this more evident than in the fact that, though inflation could perhaps be tossed-up to transitory supply chain issues, employment had already reached its frictional level. As it became more clear than inflation would persist (either because of structural problems, new lockdowns in China, and/or the Russian invasion of Ukraine), the Fed realized it would have to take a much more aggressive approach to quantitative tightening and interest rate increases. With persistent inflation and a more hawkish Fed, there could only be one direction for interest rates.



Source: Factset

BSP View: In our view, at these levels certain areas of fixed income markets have begun to look attractive, particularly low duration (2-3 year) investment grade corporate bonds, which in many cases are trading at or below par (given the recent widening in corporate spreads). To be sure, interest rates will continue their upwards march, as more likely than not, the Federal Reserve will pursue 25-50bps interest rate increases at the five remaining FOMC meetings in 2022. However, given the geopolitical backdrop and the sensitivity towards not pushing the economy into recession (i.e. a hard as opposed to soft landing), the Fed might also have to dial-back its current pace of tightening.

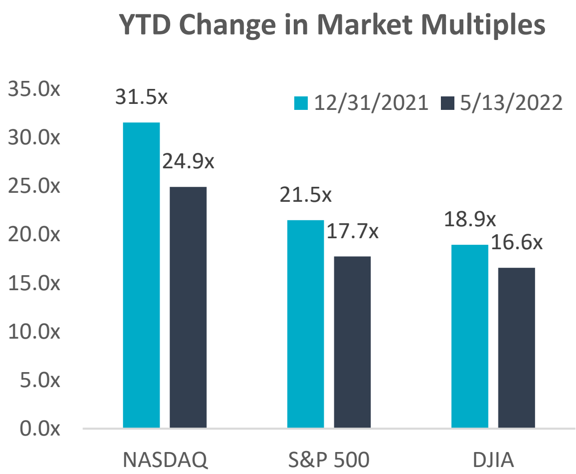
As of May, the Fed announced that balance sheet run-off of U.S. Treasuries and MBS would start on June 1st, at a pace of $47.5 billion / month for the first three months, and $95 billion / month, thereafter. From these levels, the key question is if global buyers of U.S. treasuries are willing to own treasuries at a 3.0% rate when inflation is still running around 7-8%. Though interest rate risk is firmly to the upside, our bias is for believing that the U.S. 10Y will stabilize at the 3.0% level for some time, before resuming its trend upwards.

To be clear, Fed run-off, dollar strengthening and a massive drop in the stock of global negative yielding debt are headwinds. However, until the macro picture is clearer, we are happy to collect 3-4% premiums on high quality corporate credit, knowing that recovery at par in a couple of years is extremely likely, and that our interest rate risk will be minimal. Additionally, with higher rates, we would also expect to see the role of fixed income as portfolio ballast (i.e. uncorrelated to equities) increase.

Equity Market: A Healthy Normalization

Here are some equity market stats for context:

- The S&P 500 and Dow Jones are 18% and 14% off their January 2022 highs, while the Nasdaq is 29.2% off its November 2021 high
- The S&P 500 is trading at 17.7x '22E earnings (vs. 21.5x at year-end 2021); the Dow Jones is trading at 16.6x '22E earnings (vs. 18.9x at year-end 2021); and the Nasdaq is trading at 24.9x '22E earnings (vs. 31.5x at year-end)
- YTD value is up 0.8% while growth is down 27.3% relative to growth, value has given up all of its pandemic-era outperformance
- Every FAANG stock is currently in a bear market
- SPAC stocks like Virgin Galactic, Clover Health, and AppHarvest are down between 85%-90%
- EV stocks (with the exception of Tesla which is down 36%) are down between 70-80%
- Stay @ Home stocks like Zoom, Peloton, and DocuSign are down between 80-90%
- Crypto exchanges and miners like Coinbase, Riot, and Marathon Digital are down between 80-90%



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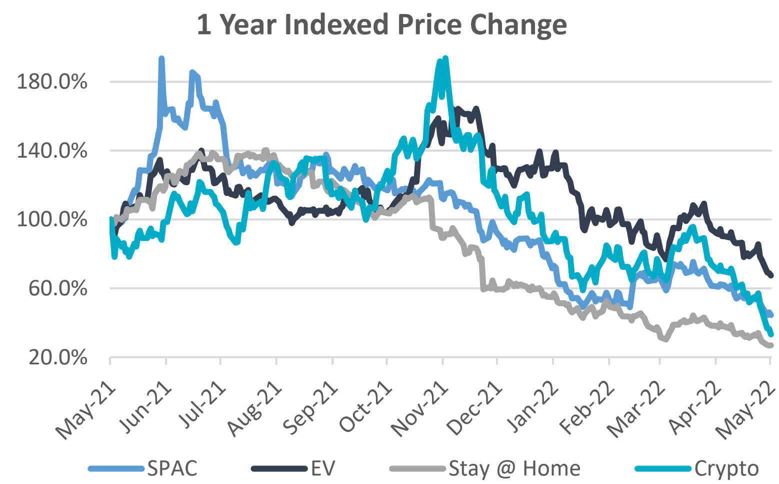


BSP View: The message here is that many of the QE-era excesses in equity markets have cleared, which makes us inclined to believe that (for investors with mid-term outlooks) the ground is much more fertile for capital deployment into risk assets over the course of 2022. To be sure, we are still operating in a very uncertain climate, and as such, we believe it is even more important to be patient and disciplined.

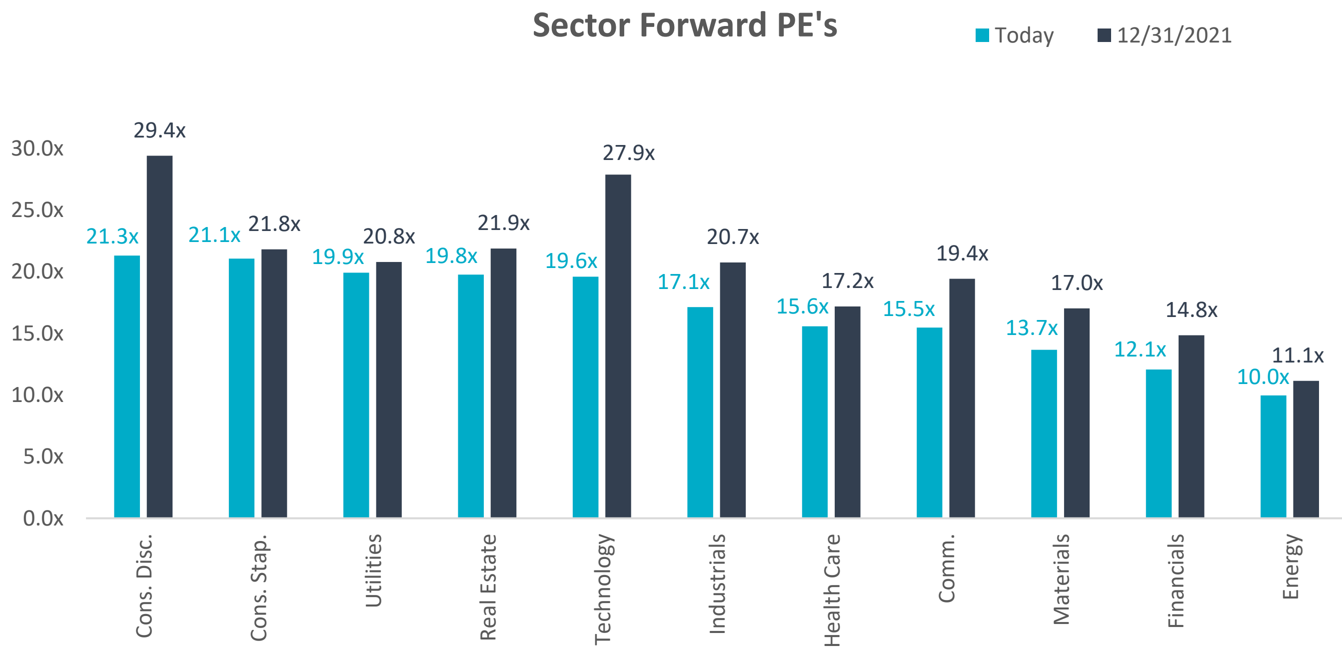
We continue to see a fairly healthy economic backdrop (all things considered), primarily because:

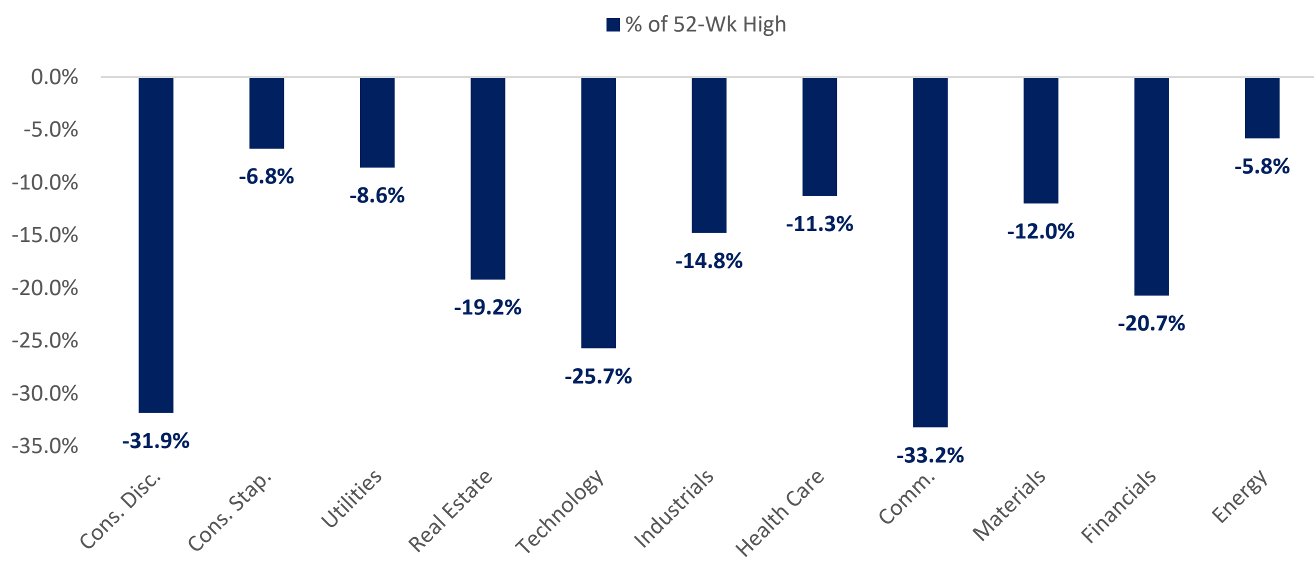
1. The American consumer is still flush with cash
2. Wages are for the most part keeping up with inflation in goods and services
3. There are still strong tailwinds from global economic re-opening
4. And a meaningful portion of inflationary pressures stand to be resolved with continued improvements in supply chain congestion, though the duration of the war in Ukraine, and the ultimate impact of Chinese lockdowns remain key sources of uncertainty

We would also note that until now, most companies have proved surprisingly resilient in preserving operating margins by passing on inflationary pressures in the form of higher prices. Growth will surely moderate, margins may slightly compress from here on out, and volatility will remain high, but the fundamental picture is not one of doom and gloom as many might suggest.

For those reasons, our equity deployment strategy is focused in the following categories:

- Value sectors with inflationary and geopolitical tailwinds, (i.e. energy and basic materials)
- Defensive equities producing staple products with high-value added components, (i.e. pharmaceuticals and medical devices)
- Financials which benefit from rising rates, but that are not exposed to decreases in capital markets activity, (i.e. regional banks)
- Certain pockets of what we call "old-tech" (i.e. profitable, cash-flow producing incumbents), where we can harvest elevated levels of volatility by selling covered-calls





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Anecdotally, we also think it is worth mentioning that, after sitting on a giant pile of cash for the better part of a decade, Berkshire Hathaway deployed ~$50 billion in equity investments during Q1 '22 alone, which is the most it has spent in a single quarter since 2008. Buffet bought ~$20 billion of additional Chevron stock (making it Berkshire's fourth largest holding), $7 billion of additional Occidental Petroleum stock, $4.2 billion of HP stock, $11.6 billion to buy-out P&C insurer Alleghany, in addition to $3.2 billion in buybacks of Berkshire's Class B shares.

Key Takeaways

As we stated in our yearly outlook, 2022 has proved to be a year of both normalization and continued volatility. We expected a correction but failed to anticipate how quickly the clearing of QE era excesses would occur. Though we mentioned Russia risk as a key factor, we by no means anticipated the brutality of the Russian assault on Ukraine, the scope of the global sanctions in retaliation, and the war's pronounced effect on global commodity markets. Confronted by these rapid changes in both equity and fixed income markets, we remain focused on the fundamental picture. We are not in the business of calling the top and the bottom of markets or of predicting short-term price movements. What is our business is to deploy capital where we believe we are receiving adequate compensation for a given level of risk. We achieve this by recommending cash-producing companies with growing and defensible economic moats at reasonable valuations.

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