

Thoughts on Investing in a Late Stage Bull Market

In this edition of our Thinking Man we will provide some perspectives on the current investment landscape as we approach the much anticipated election on November 5th. As has been the case for much of the year, we continue to maintain a “cautiously optimistic” posture for risk assets, but are sensitive to the unique set of risks and challenges facing the US and global economies.

Our base case is that the US economy will avoid recession in 2024 and 2025. The most likely scenarios are either a soft landing, with ~2% GDP growth and 2-3% inflation, or a “no landing” scenario with GDP growth above 2% and inflation above 3%. We are not totally sold on the idea of second “wave” of inflation but are conscious that there is strong historical precedent for such reaccelerations. We believe inflation will remain moderately above the Fed’s target due to structural forces which include: deficit spending, reshoring, housing undersupply, the balance of energy supply/demand, and geopolitical conflict. With inflation above target, we expect to see 10-20 Yr Treasury yields remaining above current levels for at least the next year.

However, given that the amount of money in circulation continues to be near all-time highs, we expect to see a reflationary environment that continues to support asset prices, albeit with heightened volatility. As such, we favor the following:

- Low duration over high duration in both stocks and bonds
- Fixed Income:
 - Investment grade (IG) over high yield (HY) corporate bonds,
 - Subordinated bonds from IG issuers (i.e. junior secured bonds and perpetual preferreds)
- Equities:
 - Maintain focus on quality (i.e. profitability, cash flow, and competitive advantages)
 - Value over growth
 - Cyclical sectors that trade at reasonable multiples: aerospace & defense, industrial services & equipment, oil & gas, basic materials, and data infrastructure enablers
 - More equal-weighted style exposure vs. market cap weighted
 - Check portfolio concentration risk on Magnificent-7
 - ETF’s: index methodologies and active management that filter for unprofitability (i.e. in small caps the S&P 600 vs. the Russell 2000 where 40% of companies have negative earnings)

The Thinking Man’s Approach



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Ignacio Pakciarz | CEO

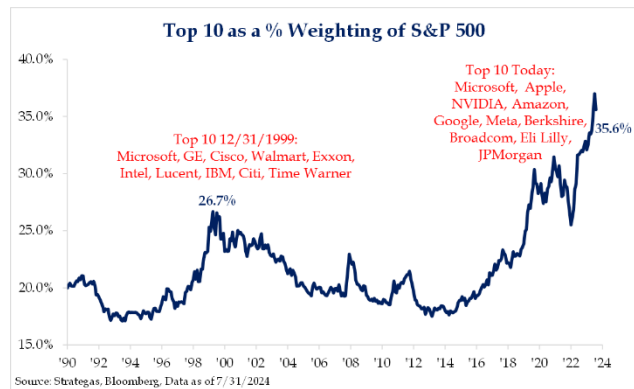
Rene Negron | *Senior Analyst*

- We see a soft or no landing scenario as being most likely, with inflation staying moderately above the Fed’s inflation target for the foreseeable future due to structural forces
- We favor high quality and low duration assets in both fixed income and equities, with a preference for value and cyclical sub-sectors
- Future business cycles are likely to be better attenuated given the expanded central banking capabilities established by the Fed, relative monetary loosening on behalf of the world’s central banks, the US preferential position as tech, energy, and financial innovator, and the expanded role of private markets
- Largest challenge for the US is an unsustainable fiscal outlook, with neither party focused on providing a solution, this is likely to drive higher interest rates for longer
- Polls, betting markets, and financial assets are pointing to a late game surge for a Trump victory, though a split government is likely the best outcome for markets

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



We have already started to see signs of rotation away from growth names to the value pockets of the market, which we interpret as a healthy broadening of market performance. Market concentration and high valuation multiples remain the primary risks to the market. However, as long as earnings continue to beat expectations, we expect to see markets bounce back from any short-term corrections (as has been the case over the last two years).



Cycle Attenuation: Central Banks, the Monetary Beauty Contest, and Private Markets

There are three big picture themes we would like to stress for readers of this publication:

1. Central Bank Attenuation: the introduction of “quantitative easing” in the crises of 2008 established the Federal Reserve as a permanent buyer of US Treasuries. This broadened scope has created a system where previously disastrous events like bank failures, market panics, and economic shocks are short-lived or non-existent (the Fed put). The broadening of the Federal Reserve’s toolkit has additionally promoted the fine tuning of monetary policy in ways that do not necessarily drain liquidity from the financial system. The result is a more resilient financial system, or in other words: a world where soft landings are actually possible, and business cycles are smoother.
2. The Monetary and Economic Beauty Contest: the primary objection to this first point above is that, though printing money can smooth business cycles, it either ultimately: (1) destroys the currency or causes (2) rampant inflation, two sides of the same coin. The crucial point to understand here is that in a world of fiat currencies, where every major economy has the ability to determine how much money it will print, the threat of currency devaluation is really only relative to what other countries are doing with their monetary policy. Ultimately what determines relative value is the flow of trade and capital, which is in turn a function of how fundamentally productive an economy is relative to others. Though the US may print money to smooth business cycles, every other major economy in Europe and Asia does the same. Meanwhile, the US remains the global capital of technological, energy, and financial innovation which maintains a steady demand for US dollars – for no other reason than that the world wants to buy the high value products and services the US sells, whether it be physical goods, oil & renewables, or financial products.
3. Private Market Attenuation: the rise of private capital which operates outside the traditional scope of the banking sector (i.e. private credit, private equity and everything in between) has meaningfully altered the structure and character of how corporate distress is resolved. Most simply, when private debt funds are lenders to the private equity funds (instead of banks) there is a higher probability that there is some form of reorganization/resolution that doesn’t result in corporations being shuttered and people losing their jobs.

The main takeaway from these points is that business cycles going further are likely to be smoother, and that in spite of frequent central bank interventions which see the money supply swell, fundamentally the

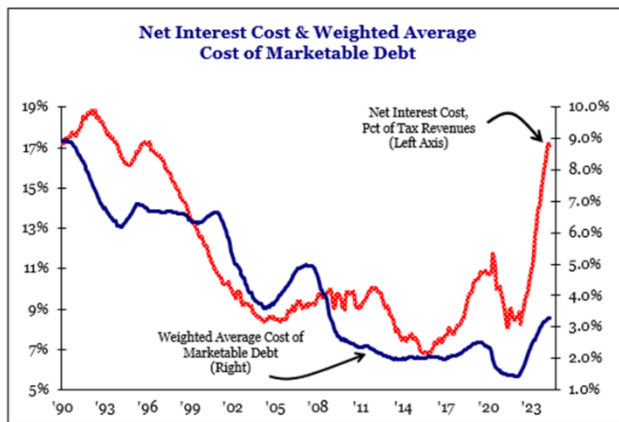


US continues to be “the least ugly” from a productivity and monetary policy standpoint. The European Central bank and the Bank of England are likely to have to cut rates and provide monetary stimulus at a faster rate than the US, while Japan will likely normalize policy at much slower pace than was expected earlier in the summer. The Chinese continue to battle serious property market and economic problems, that have forced them to routinely provide fiscal and monetary stimulus. Though the previously mentioned structural forces will keep inflation above target in the US, the fundamental strength and productivity of the US economy will ultimately keep inflation from getting truly out of check.

The 800 Pound Gorilla: Deficits and Ever-Increasing Debt

There is of course one category (outside of unpredictable shocks like pandemics and military invasions) that keep us up at night, and that is the truly abysmal fiscal outlook. According to the Congressional Budget Office, the federal deficit topped \$1.8 trillion in the latest fiscal year, driven by higher spending on interest and entitlement programs. All in all, the government collected \$4.9 trillion in revenue and spent \$6.8 trillion, putting the deficit at \$1.8 trillion for the fiscal year that ended Sept. 30. The latest deficit reading represents ~6.4% of GDP. Though the U.S. has run larger budget deficits in the past, both in dollars and as a share of GDP, those instances were during wars, economic crises, and the pandemic, not during a period like today’s environment of low unemployment and solid growth.

With \$35 trillion of federal debt, Uncle Sam is currently accruing debt at a rate of ~\$1 trillion every six months. To put that in perspective, at the present rate, over the next two years the federal government would accrue as much new debt as the combined Treasury holdings of both Japan and China, which are the two largest foreign owners of US Treasuries. What is most concerning to us is that neither a Harris nor a Trump administration are seriously discussing how they will stabilize the fiscal situation. In the meantime, the situation continues to be compounded by the fact that though the Fed has started decreasing rates, interest costs alone are expected to reach 20% of the entire federal budget by 2025.



Source: Strategas

Time Required to Reach Total U.S. Debt Levels	
Of:	
\$10 Trillion	232 Years
\$20 Trillion	9 Years
\$30 Trillion	4.5 Years
\$31 Trillion	8 Months
\$32 Trillion	8 Months
\$33 Trillion	3 Months
\$34 Trillion	3 Months
\$35 Trillion	7 Months
Latest Level	\$35.21 Trillion

Source: Strategas

There are really only four ways out of the present fiscal situation:

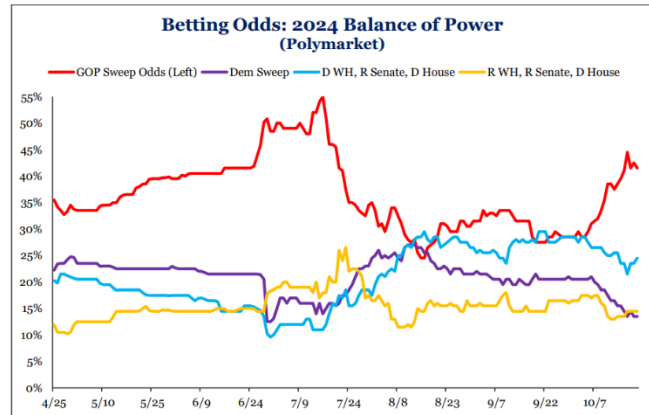
1. Increase tax revenues
2. Cut expenses
3. Turbocharge GDP growth –a productivity wave from AI
4. Devalue / accept higher inflation



It is concerning to us that there are very few politicians that are willing to tackle the issue, mostly because it is political suicide to break ranks and speak out against fiscal profligacy. Ultimately, it also the result of how polarized the country has become, and how few politicians from either party are willing to work with their colleagues across the aisle. Perhaps the only possible solutions will have to come from ideas like the Department of Government Efficiency (DOGE) where entrepreneurs like Elon Musk can bring their focus on efficiency and dollar maximization to the public sector.

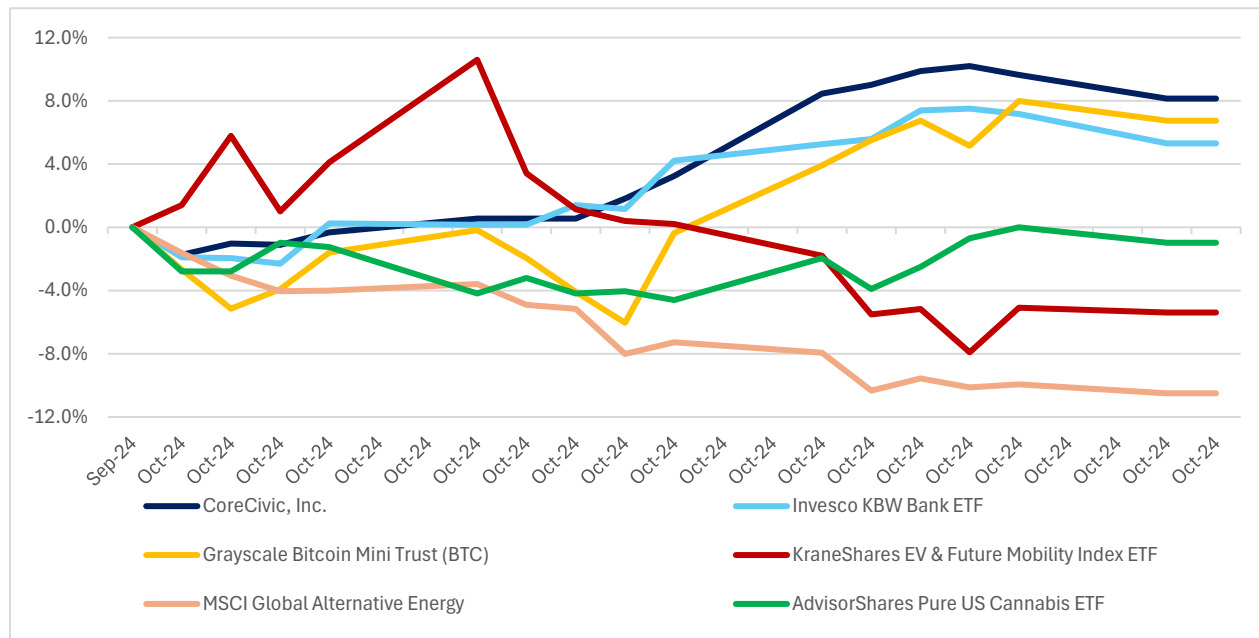
Election Tracking: Split is Likely Best for Markets

We believe that the best outcome for financial assets is a divided government – one where extreme policy from either side is kept in check by the very division of powers set forth in the US Constitution. With respect to the presidential election, Trump has very clearly taken a late game lead, and closed and surpassed all of the initial momentum that Harris achieved when she first took over the Democratic candidacy. Even a Red sweep seems more probable as support for Trump is likely to also be expressed down-ballot for Republican candidates. If this happens, one might expect an initial rally based on higher animal spirits, but could be followed by profit taking too.



Source: Strategas

The Trump lead is validated not only by polling data (on which we place less importance than in the past), but also by betting markets and financial indicators. Cannabis and EV/renewables stocks that would benefit from a Harris presidency have underperformed, while banks, private prison stocks (CoreCivic), and Bitcoin have outperformed. The Trump Media & Tech Group (NYSE: DJT) is up 95% just in the month of October.





Additionally, Vice President Harris has made a number of perceived media blunders that could have likely been avoided. Most recently, the decision to not attend the Archdiocese of New York's Al Smith dinner was widely perceived as unnecessarily breaking with a historical precedent of the political establishment. The only other Presidential candidate that ever declined the dinner was Walter Mondale, who in 1984 was famously defeated by Ronald Reagan in every single state other than Mondale's home state of Minnesota (and Washington D.C.)

Concluding Thoughts

We remain cautiously optimistic for the rest of 2024 and full-year 2025. However, given the asset appreciation of 2023 and YTD 2024, our view that inflation will remain sticky (especially in services), and the continuation of an environment of asset reflation (given the unintended consequences of balance sheet expansion from the world's central banks) we believe our clients should focus on holding only the highest quality assets, while using options to opportunistically hedge by using elevated VIX levels to write covered calls.

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