Knightsbridge
WEALTH MANAGEMENT

October 11th, 2021

Fall Quarterly Commentary

"Once again, the change in thinking that represented the end of the new era had no clear alignment with any precipitating factor, but had rather more to do with the feedback from price movements themselves"

Robert J. Shiller (born 1946)
Economist, Author, Nobel Laureate

For the first two months of the third quarter, the stock market appeared much as it did for the previous sixteen months: as an unstoppable bulldozer. However, the market's direction reversed course in September. Let's explore some of the possible reasons why.

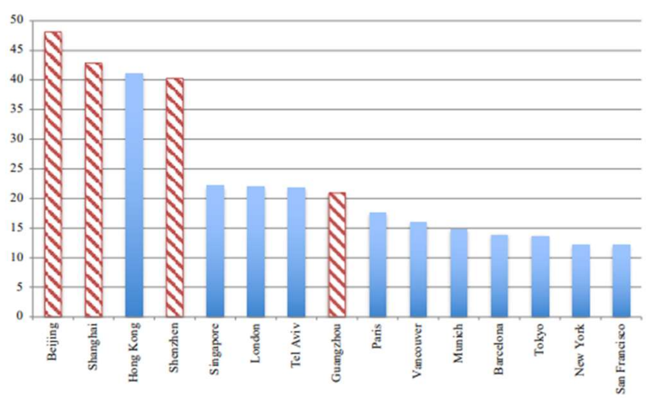
First off, there are again signs of trouble in China's overbuilt property sector. The large and indebted property developer Evergrande failed to make its most recent interest payment. The beleaguered developer's bonds unceremoniously sold off in response (see chart).

A second, smaller property developer has also defaulted on its dollar bonds. Following September's terrible (-30%) year-on-year property sales figures, investors reacted by dumping the bonds of additional Chinese property developers. An important index of Chinese high-yield, dollar bonds recently hit a decade-high yield of 18%. Investors are concerned that this is the first whiff of the oft predicted, but so far unseen, Chinese financial crisis.

Why do prognosticators keep worrying about the Chinese property market? Because the Chinese property market makes the American housing market in 2006 look balanced and rational. Take the city of Tianjin, a suburb of Beijing, for example. Luxury property there sells for about $840 per square foot, roughly on par with the most expensive parts of London. The only difference is disposable incomes are seven times higher in London than in Tianjin. Untrustworthy of the financial system, well-off Chinese prefer to store their wealth in property, often in the form of vacant apartments. This preference has crescendoed into urban Chinese holding nearly 78% of their wealth in residential property, compared to a 35% figure for the U.S. The Chinese may be running out of buying power for all these new apartments. Household debt-to-income is now 130%, a level greater than that in the United States.

Figure 4: Home Price-to-income Ratios in the World's Major Cities (2018)

This figure shows home price-to-income ratios in Beijing, Shanghai, Hong Kong, Shenzhen, Singapore, Tel Aviv, Guangzhou, Paris, Vancouver, Munich, Barcelona, Tokyo, New York, and San Francisco, respectively.



Source: Numbeo

One can envision a potential crisis which would stem from the classic problem of bubbles: that people bought assets either because they were going up or because they thought they could not go down. When the price direction changes, this can lead to a cascade of selling.

The process could go something like this. Capital markets no longer want to lend to Chinese property developers (this is already happening and reflected in the higher bond yields). Chinese property developers need cash and thus try to sell more of their apartments, and they do so by lowering prices. Chinese citizens see that prices are falling and no longer want to buy vacant properties as investments, or worse, sell the ones they already have. This leads to further price pressures.

What is the end result? Property prices plummet, a lot of people are suddenly a lot poorer[1], and many in the real estate industry are out of work. If the pain stops there, this would be a classic industry downturn. What would be worse (a recession) is if the Chinese government/system failed to get those displaced workers back to work quickly. What would be even worse is if investors, seeing the losses on loans to property developers, suddenly get scared and don't want to lend to *anyone*. That then puts all sorts of people in *other* industries out of work. That is how a financial crisis causes a depression.

We wrote extensively about these excesses during 2012 – 2015. Rather than reversing, the Chinese property market simply continued to inflate. Thus, one maxim we always try to keep in mind is, "Things can always get crazier". And, so far, they have.

Even if there isn't any financial contagion just yet, problems from China are reaching the U.S. As anyone who has purchased a car or practically anything online recently knows, limited selection, long lead times, and delayed deliveries abound. To put it bluntly, the global supply chain is a mess. In our Spring Market Commentary, we wrote about the unprecedented number of containerships sitting here off the coast of Newport Beach, waiting to unload at the ports of Long Beach and Los Angeles. The queue has more than doubled since that time[2].

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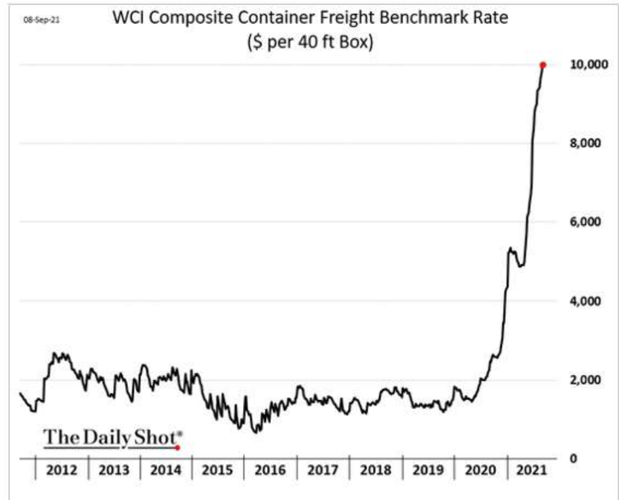
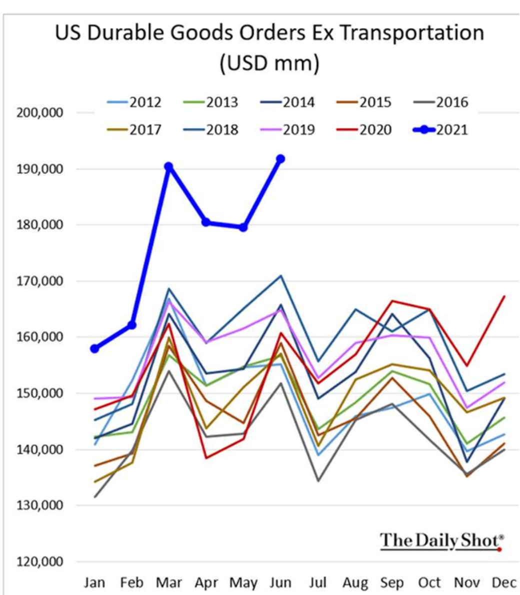
[1] It would probably be more accurate to say that people suddenly *realize* they're not as rich as they thought they were. They were under an illusion of prosperity that was shattered.

[2] It is looking increasingly likely that one of the ships, pushed out of regular anchorage locations due to the long line, dropped an anchor that disrupted an undersea oil pipeline causing up to 131,000 gallons of oil to spill into the waters off coastal Orange County, an unfortunate and unforeseen casualty of the pandemic.



There are three main factors behind the broken supply chain. The first factor has nothing at all to do with the supply chain being broken, it is simply overloaded! The unprecedented monetary and fiscal stimulus of the pandemic, paired with various shutdowns, produced a tectonic shift services to goods (home improvement, etc.). We're trying to send more products than ever through a supply chain that wasn't built to handle that kind of volume.



The second cause of the snarls is more straightforward: COVID-related shutdowns. This past quarter, China periodically closed some ports due to outbreaks, thereby reducing capacity. COVID-related factory shutdowns have also occurred in China and other countries.

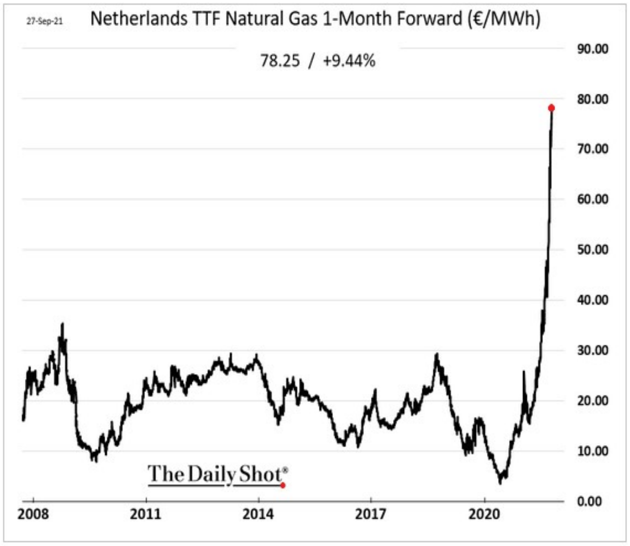
Surging demand coupled with impaired capacity creates ripple effects, which are the third factor. Previously, the supply chain was so optimized that disruptions now have knock-on effects. An example here is in order. With the greater demand for goods from China, which are usually shipped in standard-sized containers, there is a container shortage in China. Containers are now often sent back over the Pacific empty, while in more normal times they would be filled with American grain. This means that sometimes when American grain arrives in West Coast ports for export, there are no containers. The grain instead sits in a warehouse... where it takes up storage space needed to unload container ships arriving from China. And around we go.

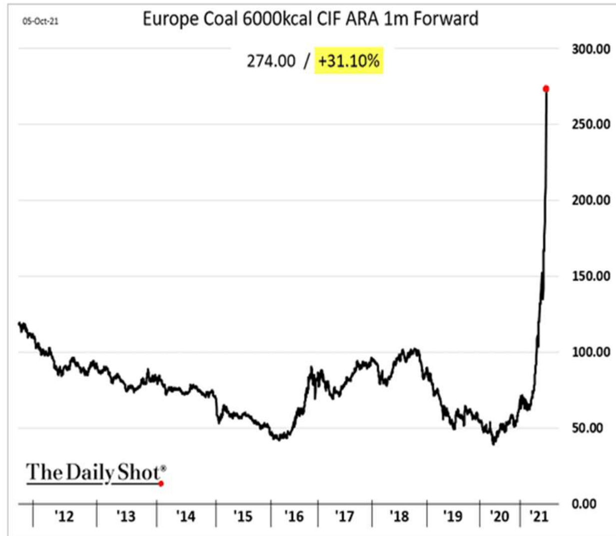
Recently, the disarray has carried over into the energy markets. The world's most important commodity, oil, is nearing a six-year high. The rise has been swift, though this long-term chart of the most important global benchmark for oil helps keep things in perspective.

Source: Finviz

Rising energy prices have hit Europe the hardest, particularly with commodities that are not easily transported around the globe (i.e., natural gas and, to a lesser extent, coal[3]).

[3] High coal prices in China are also contributing to supply chain issues, as authorities are demanding that some factories limit their operations to conserve power to keep retail electricity prices down.



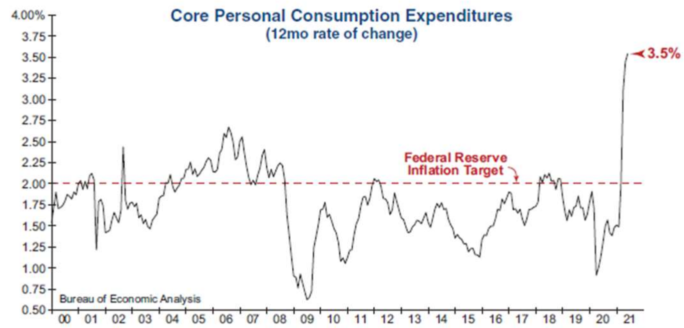


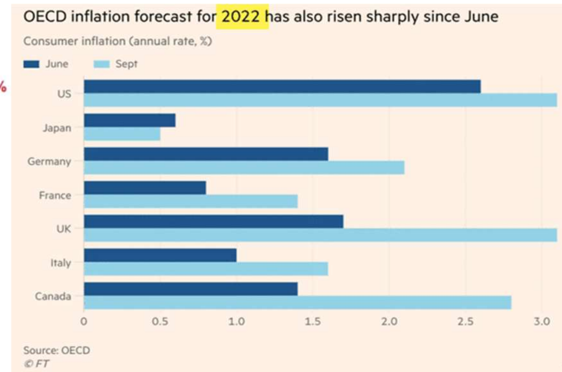
Energy prices are spiking in spite of (perhaps even partially due to) the "green" transition away from fossil fuels. This transition *is* real, and it *is* coming. It will likely offer some attractive investing opportunities along the way (a topic to be covered later). Be that as it may, this transition is initially only underway in developed countries. It is happening slowly and we use oil for a lot more than just filling up our cars. Think about the late 1990s dotcom boom. The internet was indeed real and the digitization of everything was indeed happening. But it didn't happen overnight, and it didn't displace traditional industries immediately. That happened later (indeed it is still happening). For the time being, the energy pinch is going to at least dent the European recovery, and electric vehicles are not coming fast enough to prevent it.

The U.S. energy industry, as discussed in previous letters, has continually expanded production over the last decade, with few profits to show for it. Word on the Street is that banks and investors, burned from throwing good money after bad at unprofitable energy companies, have perhaps learned their lesson and are reluctant to do so again. Thus, there is a distinct possibility that the U.S. energy sector will not respond to higher prices by again ramping up the old production machine as it has in the past.

The U.S. recovery could probably withstand $80 a barrel oil. But $100? $120? We wonder whether there could be a very pronounced spike due to years of underinvestment in conventional oil extraction after the price dropped in 2014 due to expanded (largely unprofitable) fracking operations. In the 1980s, the price of oil similarly collapsed concomitant with the introduction of a new supply source (the North Sea oil fields). It was only a full 10 years later, and after many false starts, that oil prices and industry profitability recovered. We have been using this highly unscientific waiting period before dipping our toes back into the energy sector. Perhaps we waited too long.

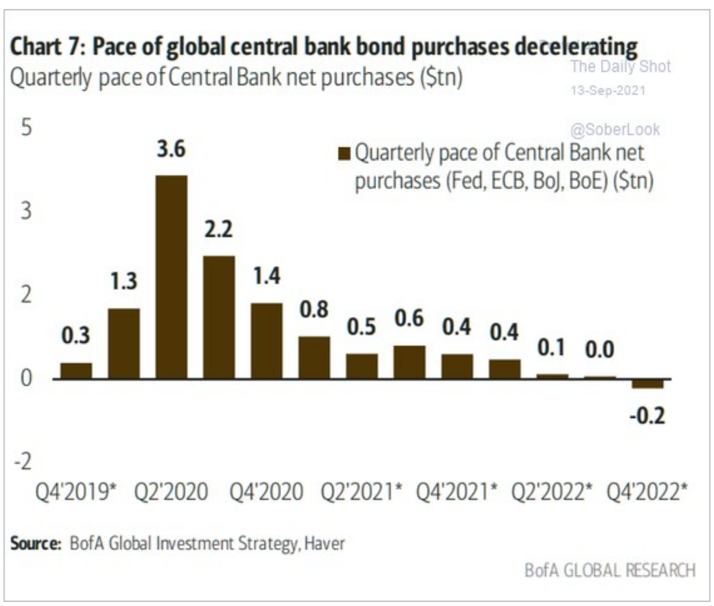
With energy prices on the ascent, we can be much less certain that inflation is "transitory". The Fed's preferred measure of Core Personal Consumption Expenditures (PCE) finally registered a "high" reading, clocking in at 3.5%.





Any inflation paints the Fed into a corner, under pressure to tighten monetary policy. It is our opinion that large moves in the general level of the stock market are most often driven by monetary factors. Thus, of all the threats to the stock market discussed in this letter, we judge the prospect of changing monetary policy to be the most concerning.

Indeed, the Fed is talking about just such a move, with the impending "tapering". The plan is not to raise short-term interest rates, but merely to reduce the amount of bonds it is buying with newly printed money.



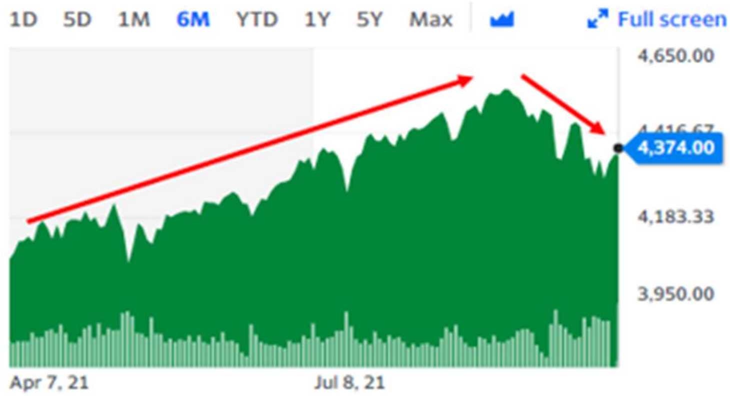
So, if tightening monetary policy is what kills bull markets... does this count? Keep in mind, the Fed will still be printing dollars, just fewer of them. Only the second derivative[4] of the Fed's balance sheet will change from positive to negative. Fed rate hikes are not projected to occur until late next year.

The stock market is at least stopping to consider these concerns. September was the first down month in some time.

[4] The rate-of-change of the rate-of-change.

The overall direction of the market can be influenced by a small handful of the largest companies. We are more concerned by the market's deteriorating breadth, which is defined as how many individual stocks are falling vs rising. Below, we show the percentage of S&P 500 Index constituents trading above their 200-day moving average.

S&P 500 Over the Last 6 Months



Source: Yahoo Finance

S&P 500 Breadth

Deteriorating breadth can sometimes precede a change in overall market direction. Last quarter we wrote, "we are in a bull market until proven otherwise". It hasn't quite been "proven otherwise" yet, but we are certainly one step closer.

Another concern we are often asked about is politics. How are we planning to respond to the large spending bills and accompanying tax increases the Democrats are planning? Are we concerned? The short answer is that we *are* concerned, but no, we are not doing anything about it. The long answer appears below.

When it comes to additional government spending, the impact to the economy is just about always positive in the short term. Additional government spending boosts near-term economic demand, which means more people earning and spending money. It doesn't really matter whether the additional spending is good or bad for the country (such a determination is inherently subjective anyway). Additional spending equates to a stronger economy in the short run, and that usually means a stronger stock market[5].

[5] Additional government debt from additional spending does present additional risks in the long-term (such as, but not limited to, potentially higher taxes in the future). There are also (mostly theoretical) exceptions when higher

The flip side of this coin is that higher taxes are almost always bad for the economy and the market in the short-term. And the Democrats are considering myriad tax increases[6]. A by-no-means exhaustive list of the considered provisions:

Capital Gains Realization at Death	**Increase Corporate Tax Rates**
Global Minimum Corporate Tax	**Corporate Accounting Earnings Minimum Tax[7]**
Top Personal Tax Bracket Increases	**Top Bracket Capital Gains Tax Increase**
Carried Interest Elimination	**Estate Tax Reforms (elimination of GRATs and IDGTs)**
Mark to Market Gains for Billionaires	**Limiting the Size of IRAs**

These provisions, if adopted, will certainly matter, not only for your pocketbook but also for the stock market. So why aren't we reacting? Because that "if" is a pretty big if. When it comes to changes in the tax code, there are many sources of uncertainty, some of which we list below:

1. **What does the party in power *want* to do?**
2. **Which provisions actually make it into the various preliminary bills (committee draft version, House version, Senate version, etc.)**
3. **What makes it into the final proposal?**
4. **Will the final proposal actually get passed and signed by the President?**
5. **What will stand up in court?**
6. **How long until the law is changed again?**

When it comes to the impact of the proposals listed above, we are specifically skeptical about the above steps #3, #4 and #6. The Democrat majority in the Senate is a razor-thin one vote. They need complete unity with no defections. That is a tall order, as recent news-flow confirms. Democrats need campaign donations too. Do we really think there isn't

government spending might be bad for the stock market. Such as when high inflation is already causing the stock market to sell off. In this situation, additional government spending might increase expectations of future inflation, thereby worsening the sell-off.

[6] There is at least one tax decrease on the table. Some Democrats want to make SALT (State and Local Taxes) completely deductible again, as they were before the 2017 Tax Cuts and Jobs Act.

[7] We have seen estimates indicating that if the three corporate tax provisions listed above were adopted as currently envisioned, they would result in a 5% hit to S&P 500 earnings in 2022, with certain industries such as technology feeling more of a pinch. Unwelcome but not catastrophic. Attempting to avoid this hit by sitting out of the market since the presidential election would have meant missing out on the ~20% of S&P 500 gains that have transpired since then.

enough anti-tax money out there to convince a single senator (or a few representatives) that certain provisions need to go? We shall see.

Uncertainty source #6 is especially important when it comes to changes in capital gain or realization-at-death tax provisions. It has been suggested that some investors might sell their stocks now, to avoid the higher capital gains rates of the future, or in anticipation of not receiving their stepped-up cost basis at death. We think this highly unlikely. Sellers would incur substantial capital gains taxes *today*. Even if these provisions were certain to become law (which they aren't), investors could simply continue to hold onto their gains and hope that a future congress rolls back the increases before it is time to sell.

For all these reasons, we will deal with any potential tax changes if and when they occur.

We do have some good news to report! In addition to researching companies, part of our individual equity selection process involves researching "investment anomalies" which we roughly define as stock market events that regularly, on average, signal future appreciation for individual stocks in excess of the broader market. Some time back, we discovered a new anomaly and have since been testing it, with encouraging results. We have been pleased this year to be rolling out this research enhancement to investor portfolios and expect it to make a meaningful positive impact on investment performance. Over time, we expect our portfolios to hold a few more positions and for our average holding period to slightly shorten. We will still maintain our tax sensitivity, though with shorter holding periods some of this efficiency will be given up. We expect this small drawback to be outweighed by higher returns. We are excited about what the future holds, as our statistical and real-world testing indicate this anomaly will help add to performance in both up and down markets.

As always, because our money is invested beside yours, whatever the future holds, we will face it together. We appreciate you being on this journey with us.

Sincerely,

John Prichard

John G. Prichard

Miles E. Yourman

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

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