October 10th, 2023

Fall Quarterly Commentary

"Come gather 'round people
Wherever you roam
And admit that the waters
Around you have grown
And accept it that soon
You'll be drenched to the bone
If your time to you is worth savin'
And you better start swimmin'
Or you'll sink like a stone
For the times they are a-changin'"

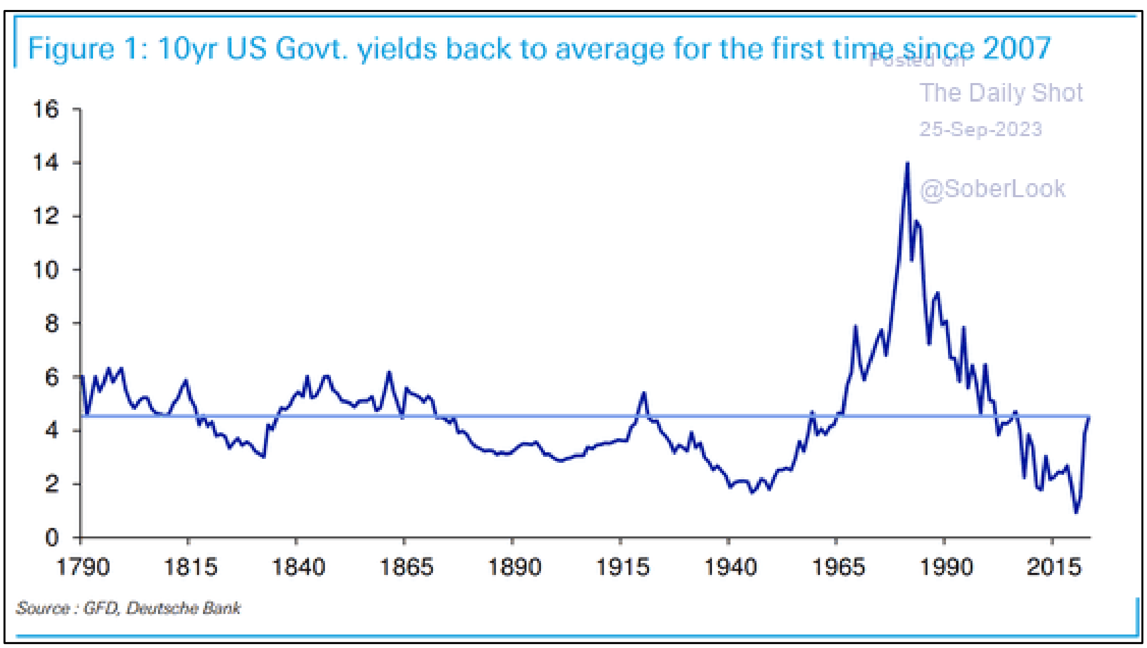
Bob Dylan (Born 1941)
Singer-songwriter

Last quarter, as the yield on the 10-Year U.S. Treasury bond poked its head above 4%, we wrote about the implications of longer-term interest rates remaining higher for longer. This quarter, the rate jumped from 4.0% to 4.8% at breathtaking speed (mostly during September).

The 10-Year U.S. Treasury interest rate is probably the single-most important number in finance. It is the starting point for nearly all financial valuations and the roughly $26 trillion of outstanding Treasuries[1] underpin the financial system.

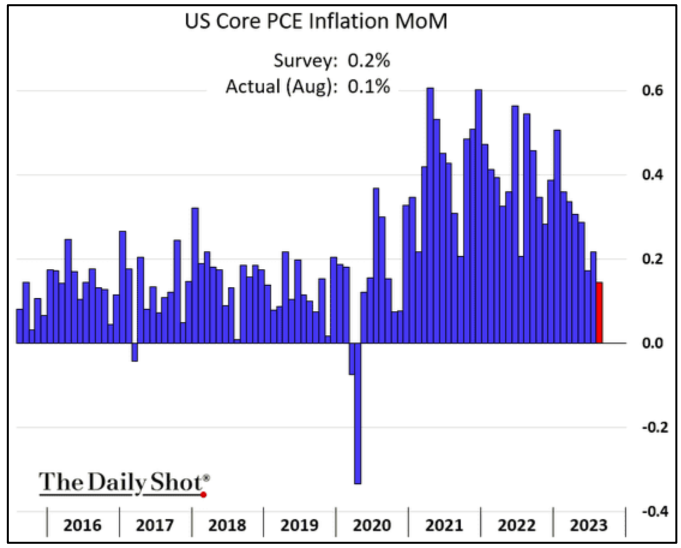
Warren Buffett has rightly characterized interest rates as acting like gravity on financial assets. It is difficult to overstate the impact of gravity increasing 20% last quarter. After a long post-2008 Financial Crisis experiment with money printing that left interest rates near zero, the 10-Year yield is suddenly back to its long-term average.

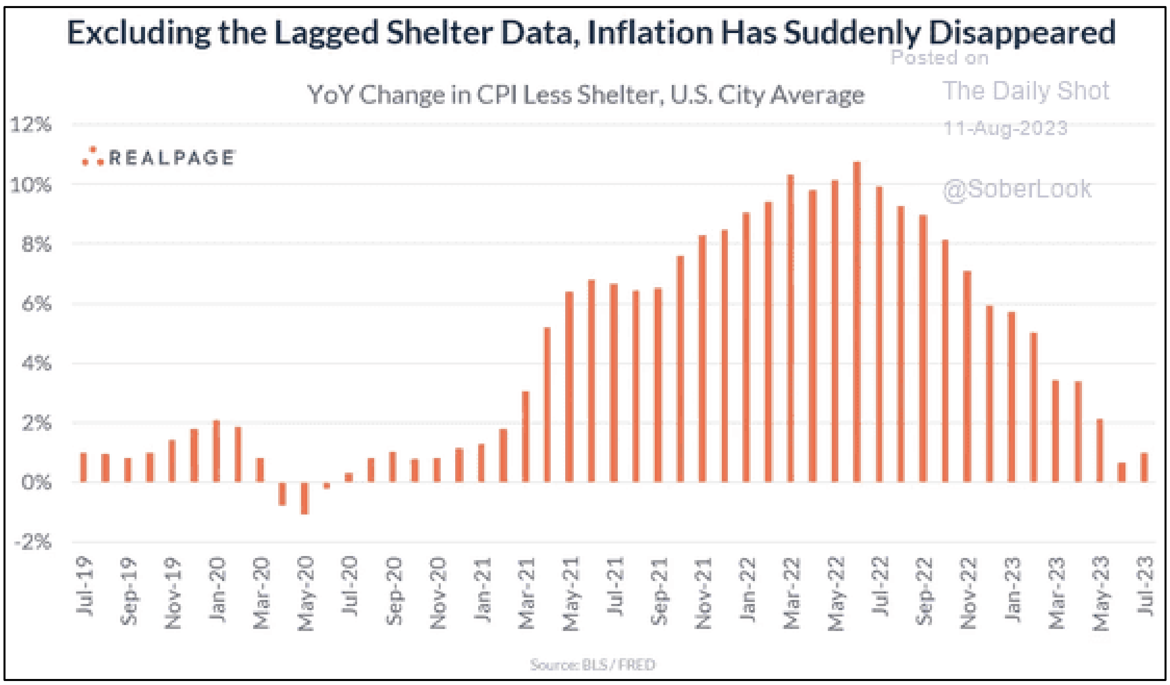
It's not just the level of rates that matters. Sharp increases like we just experienced can have destabilizing consequences, especially when there is no clear reason for the change. We expect asset prices and investor behavior will need to adjust.



[1] This is the amount outstanding across all maturities and it has doubled over the past eight years. Interest rates on longer maturities have seen similarly large increases.

Why the recent spike in longer-term interest rates? The Federal Reserve directly raises and lowers *short-term* rates, which only indirectly affects long-term rates. The market, not the Fed, is the ultimate arbiter of long-term rates. Thus, we can't point to "the Fed". We also cannot blame "inflation" for the recent jump in rates. Inflation has continued to mellow toward the Fed's 2% target, with measures excluding shelter at even lower readings[2].





We can't be entirely certain of the reason rates are shooting up; unfortunately, markets don't explain their moves. But we do see a couple of contending explanations.

Maybe it's because the much-anticipated recession has been canceled (so far). The U.S. economy has been resilient and remains unbroken by much higher short-term interest rates... so perhaps those high short-term rates will be around for longer. After all, if the short-term persists long enough, it eventually becomes the long-term.

[2] While shelter prices certainly matter to overall inflation, they are often excluded by economists and market participants because of extreme lags in reporting data.

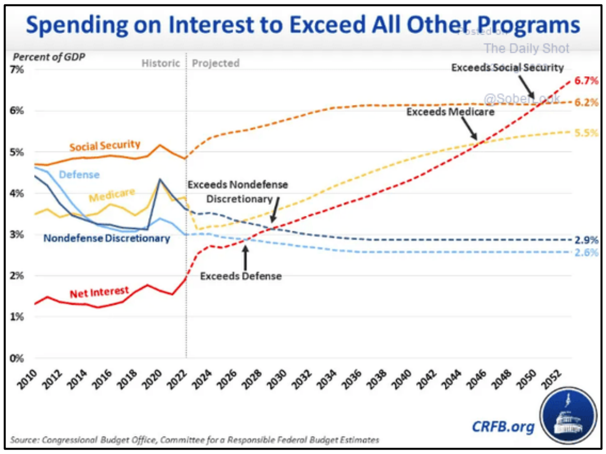
It could also simply be a good, old-fashioned imbalance between buyers and sellers. The Fed is the big swing player in the bond market. After buying bonds for years, the Federal Reserve is now selling $60 billion of bonds each month, reducing its $8 trillion dollar balance sheet by over $1 trillion in just the past year[3]. Meanwhile, the government is running ever larger deficits, which require selling more bonds to plug the gap between revenues and expenditures. On top of that, banks have been de-risking away from longer-term bonds due to their recent difficulties. That's the situation on the sell side.

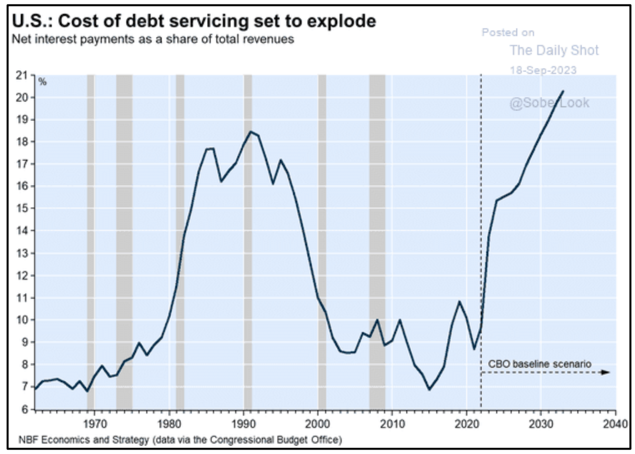
As to buyers of bonds, our largest foreign creditor, Japan, is probably more content to buy local bonds now that the country's yields have finally turned positive. Also, the strong U.S. dollar means that foreign central banks don't need to buy as many U.S. Treasuries to maintain their desired allocation to our market. Lastly, retail investors, smarting from generational losses on their bond portfolios during 2022 and 2023, may be starting to shy away.

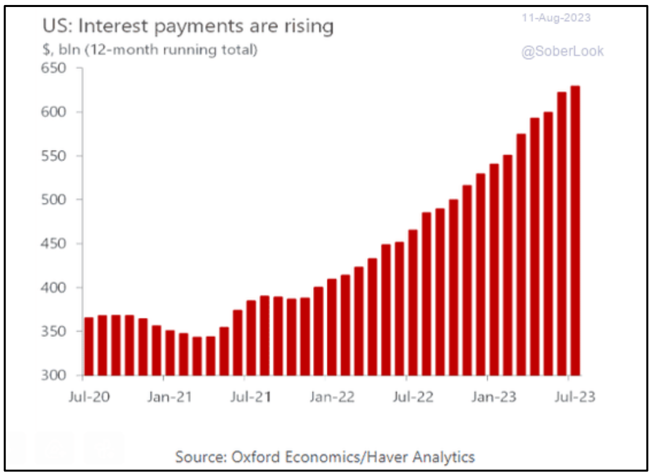
Last quarter, we discussed the potential ramifications of rates staying higher for longer: 1) the return of banking issues, 2) a frozen housing market, and 3) the plight of indebted companies (first those with floating rate loans and, later, those with fixed rate loans which have to be refinanced). Those issues remain, and we are going to throw another concern into the mix – the U.S. budget deficit.

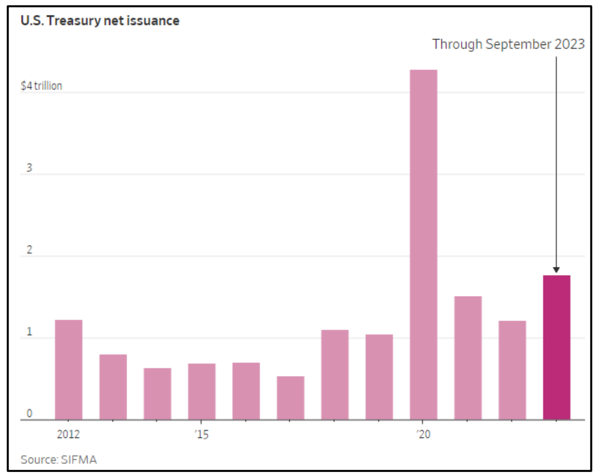
Higher interest rates increase pressure on the U.S. government to do something about its debt problem. Everyone knows the government is running huge, unsustainable deficits... and that it also doesn't seem to matter. At least, it hasn't until now. In the past, with ultra-low rates, we could have a growing government debt burden, but still apportion a relatively small portion of the budget toward interest payments. That dynamic is now changing in a big way and interest costs are exploding higher. This is driven by a combination of the government issuing more debt, while at the same time the cost to service our existing debt is increasingly burdensome as low-cost Treasuries mature and are re-issued at today's higher rates. It all adds up to some chilling forecasts of government finances – both short and long-term.

[3] As we have noted before, this is in essence reverse money printing. Because when the Fed sells bonds, they receive cash that is then retired and not put back into the system.

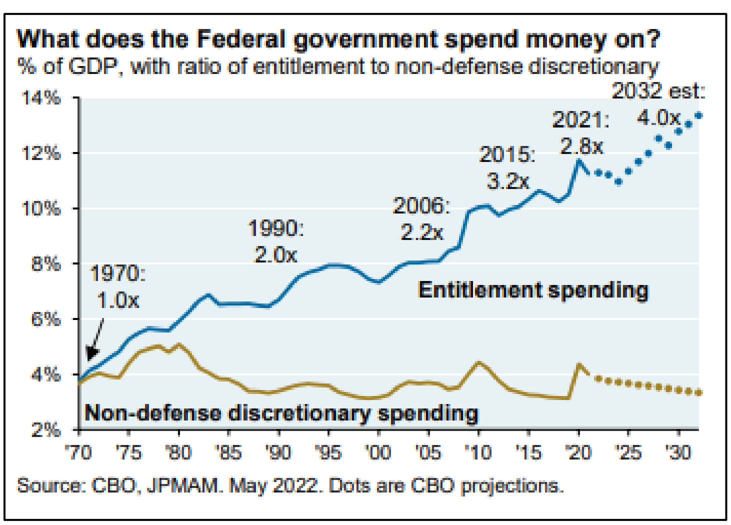








With interest payments set to increasingly chew through a larger portion of the U.S. government budget, will we see solutions proposed in the coming election year? The unfortunate truth is that this is extremely unlikely. Neither political party seems remotely serious about closing the deficit. But, before you blame politicians, consider that perhaps the ultimate blame lies with the American people, who, despite what they say, don't seem to want to close the deficit at all. Closing the deficit would likely require both curtailing entitlement spending and raising taxes. You can't close the deficit by cutting other forms of spending because there simply isn't enough money being spent there.



Would you vote for a politician campaigning on raising your taxes while cutting your Social Security and Medicare benefits? Solving our debt problem currently represents politically untenable pain. While taking these actions would be good for the country's long-term fiscal stability... they would send the economy and stock market roiling in the short-term. Imagine, as one example, the substantial hit to corporate earnings if the corporate tax rate returned to 35% from the 21% enacted in 2017. That would imply a corporate earnings haircut of 18%. As for the economy, 68% of GDP is personal consumption; increased taxes or decreased social security payments would reduce consumer spending and economic vitality accordingly.

Increasing taxes and/or reducing entitlements are "third rail" issues we don't expect to be addressed any time soon... but the pressure to do so is building. When will deficit spending and the level of government debt be deemed a problem that must be dealt with? It is impossible to tell. Debt can certainly continue to increase if everyone (both borrower and lender) allows it... the answer to how much becomes too much lies within the subjective question of when confidence is lost. Since we expect that question to eventually be answered, we believe it is prudent to look at opportunities to invest beyond U.S. equities, especially because they have been the dominant investment for years.

What about the idea of owning bonds? When interest rates rise, as they have, they cause the current price of long-term bonds to decline, even though all promised interest and principal payments remain likely to be paid in the future. Against that backdrop, many investors are asking the question, 'Why own bonds at all, when simply sitting in cash[4] pays 5% or more?' While cash may feel like a warm, cozy blanket, there are good reasons to own bonds today.

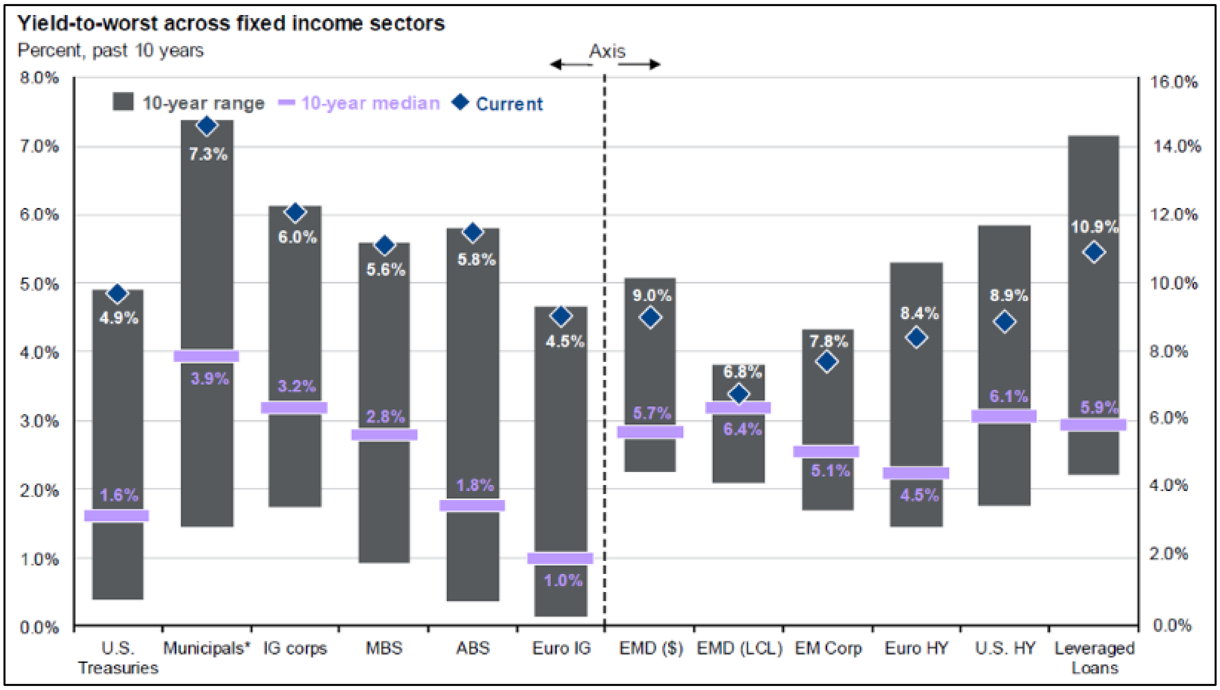
First, when we buy bonds, we are typically buying those which yield more than cash. Our portfolios include solid corporate bonds which offer yields in the neighborhood of 6%. We are also buying California municipal bonds which, at a tax-free 4% yield, are equivalent to a taxable yield of 8% for a client in a high tax bracket.

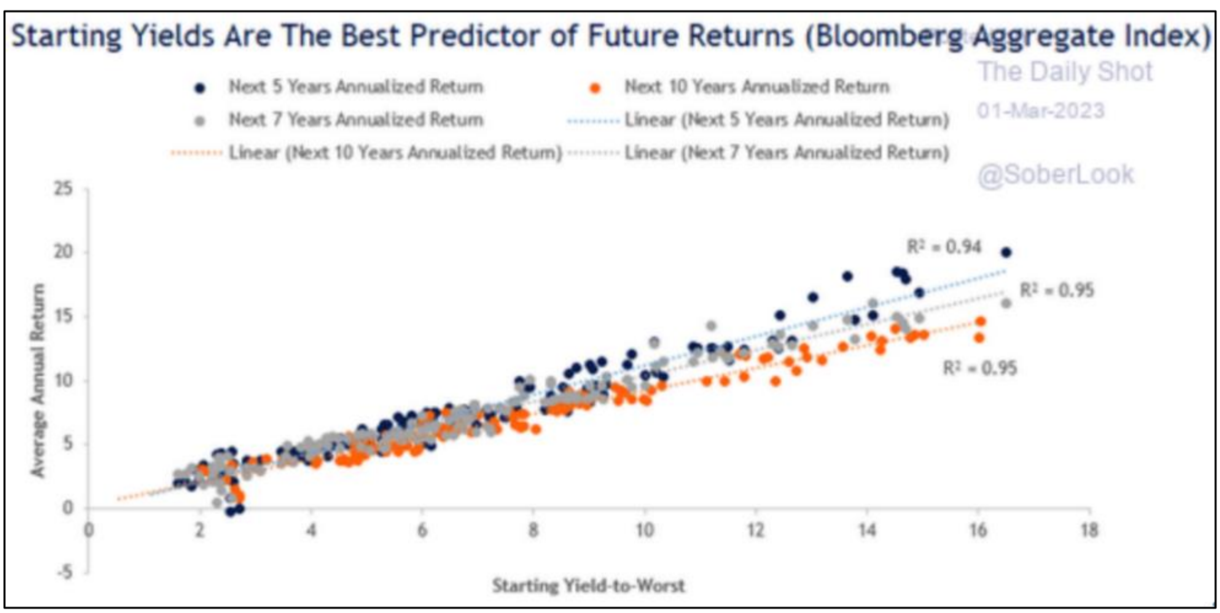
Further, when we buy a bond, we look to hold it, and therefore lock in its yield until maturity. The price of that bond may fluctuate as rates change. Barring a default, however, our client will receive all promised payments and the expected yield on investment. If and when the Fed eventually cuts interest rates, bondholders will continue with their fixed rate while hoarders of cash will see diminishing rewards. Consider those who purchased 6% bonds with 15 years to maturity in the year 2006. It sure was nice to collect that 6% per year while those who sat in cash literally received no income once the Fed chopped interest rates down to zero. To simplify the proposition for bonds, if interest rates remain

[4] More technically, we mean money market funds, which are liquid and low risk like cash in a bank account, but generally yield more interest.

at today's level or decline, you will be better off owning bonds versus cash.

While we know that interest rates will cause bond prices to fluctuate, the below two charts more fully foretell the future for bonds. Firstly, bonds today offer their highest yield in more than a decade. Secondly, the starting yield has been the best predictor of fixed income returns over multiyear holding periods. Returns will be mid-single digit going forward.



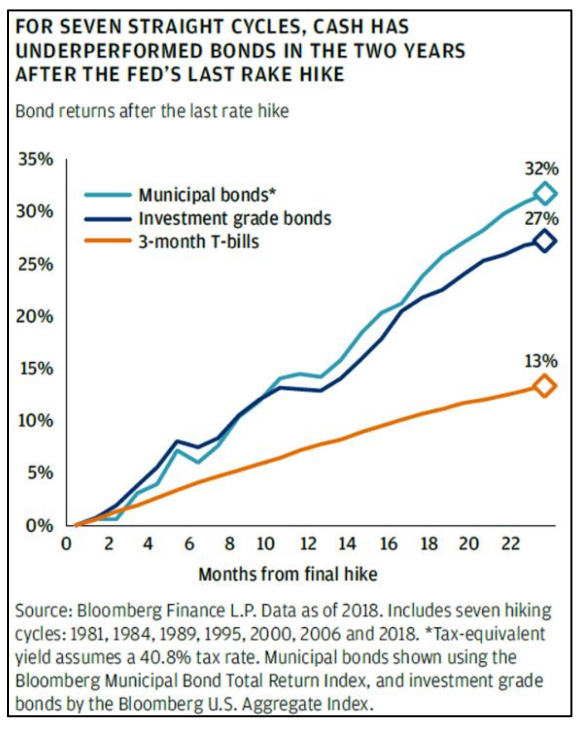


Rates may rise or fall, but ultimately, if held to maturity, the starting yield is what you will earn. Another, perhaps surprising reality is that as a long-term bond investor, a rise in interest rates *benefits* you. You will have more money at maturity, as you reinvest the interest you collect at higher interest rates. For example, a buyer of a 10-year bond with a 4.8% annual coupon will have turned $100 into $159.81 at maturity if coupons are reinvested at 4.8%. If that buyer were able to reinvest along the way at 6%, they would instead have $163.27 after ten years.

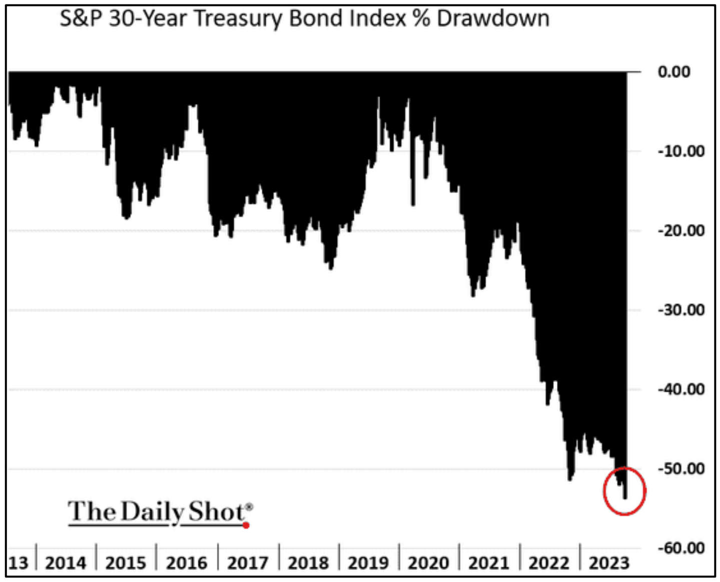
Inflation is the mortal enemy of bonds because it eats away at the purchasing power of investment returns. But higher interest rates are a sheep in wolf's clothing... they make returns *appear worse* initially, even though they will be *better* in the long run. We currently reside in a situation which is *good* for bond returns going forward... inflation is down but interest rates are up.

As outlined above, long-term bond investors fare better in an *absolute* sense when interest rates rise. Bondholders are also likely to do *relatively* well compared to stocks in the event of economic weakness. As we wrote in our last letter, perhaps the recession hasn't been cancelled, only delayed. A delayed recession scenario would look something like this: the economy starts to weaken, with increased unemployment and lower corporate earnings (earnings are indeed down slightly over the past year). Lower earnings cause stock values to fall. The Federal Reserve responds to the economic weakness by lowering short-term rates. Long-term rates then follow short-term rates downward (to a lesser extent), and bond prices *increase*. Investors who own bonds are then happy their rising bond position helps offset losses on their equities. A scenario like this often plays out after the Fed has finished hiking rates... a situation we may be in right now.

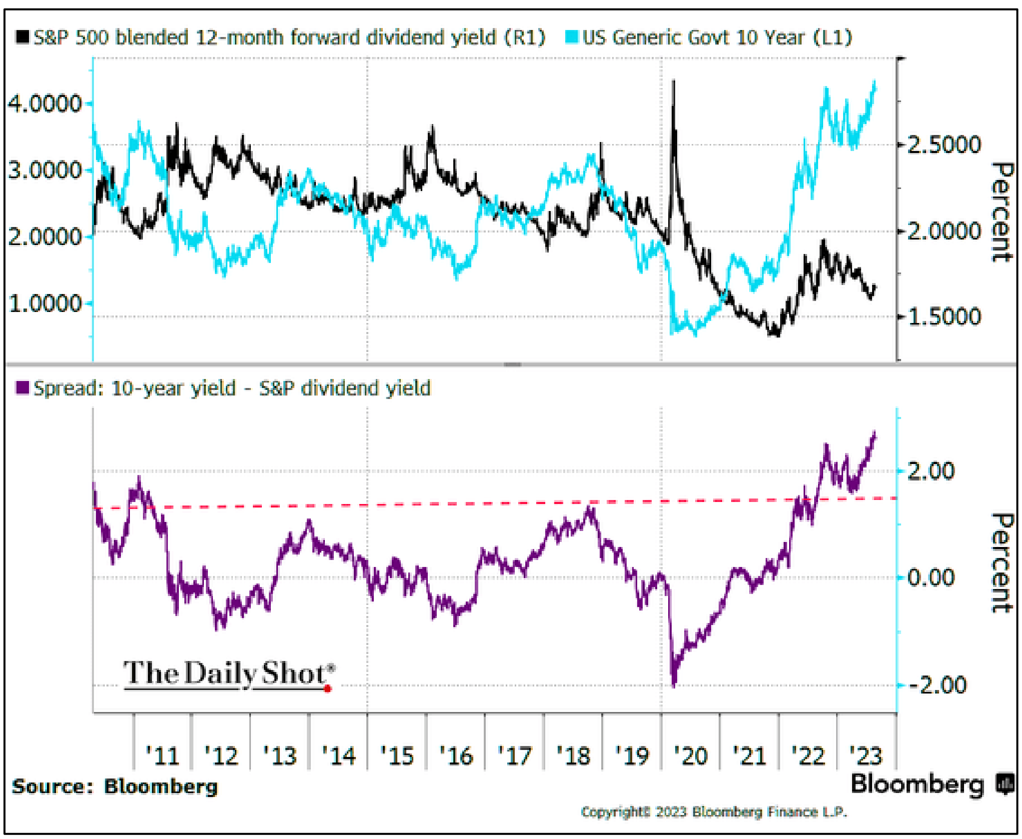
The Federal Reserve opted to not raise short-term interest rates at its last meeting. The swift move in the 10-Year Treasury rate from 4.0% to 4.8% since that meeting is likely to make the Fed cautious on any further rate hikes. If the Fed has finished raising rates, history argues it is a good time to own longer-term bonds (because long-term rate declines usually follow). The chart to the right shows that bonds have produced excellent returns over the two years following the Fed's final rate hike.



We mentioned that higher interest rates act like gravity on asset prices. That gravity immediately affects bond prices while stocks tend to drift a bit more slowly. The chart to the right shows the absolutely massive 50% drawdown by the 30-Year Treasury Bond from its 2020 high, punctuated by a 15% plunge this August. On the other hand, as we go to print, the S&P 500 Index is 6% off its July 31st high.

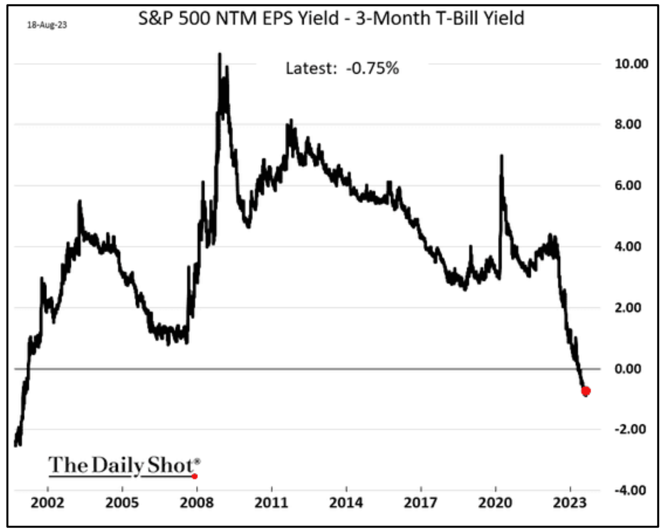


Thus, bonds have gotten cheaper while stocks have been rendered relatively more expensive. This can be illustrated by comparing the dividend yield or earnings yield of the S&P 500 Index to what can be earned with cash or bonds. A 10-Year Treasury now produces interest three times the rate of dividends on stocks. A year's worth of income on cash now exceeds a year's worth of earnings on stocks[5]. These are profound changes to the investment landscape.



[5] Here we are using the 3 month T-bill yield to approximate the yield on cash.

Indeed, these comparisons are not only illustrations of how bonds compare more favorably to stocks versus the recent past, but they are also the very *reason* why stock returns may suffer in the future: stocks may decline as they are deserted by investors who seek to lock in the higher returns that bonds now offer.



Higher interest rates are unequivocally bad for stocks in a few ways. Higher rates assert the downward gravitational pull of money toward bonds while also slowing the economy as it becomes more difficult for borrowers to spend... and we aren't just talking about consumers. In recent years, many CEOs took advantage of low interest rates to borrow cheaply, using those funds to buy back their own company's stock, resulting in a constant upward pressure on share prices. With rates now higher, those same companies may need to devote cash flows to paying off those debts, cutting back on share repurchases as a result.

We have long argued that stocks *deserve* what have been unusually expensive valuations, because interest rates have been unusually *low*. That has now changed, and we may see equity valuations adjust accordingly. We are not calling for a crash, but stock market returns could turn into a bit of a slog. Valuation is not a great trading or market timing tool. It is helpful, however, in thinking about asset allocation. Current valuations make us happier to own cash and bonds versus years past, especially with both yielding in excess of 5%.

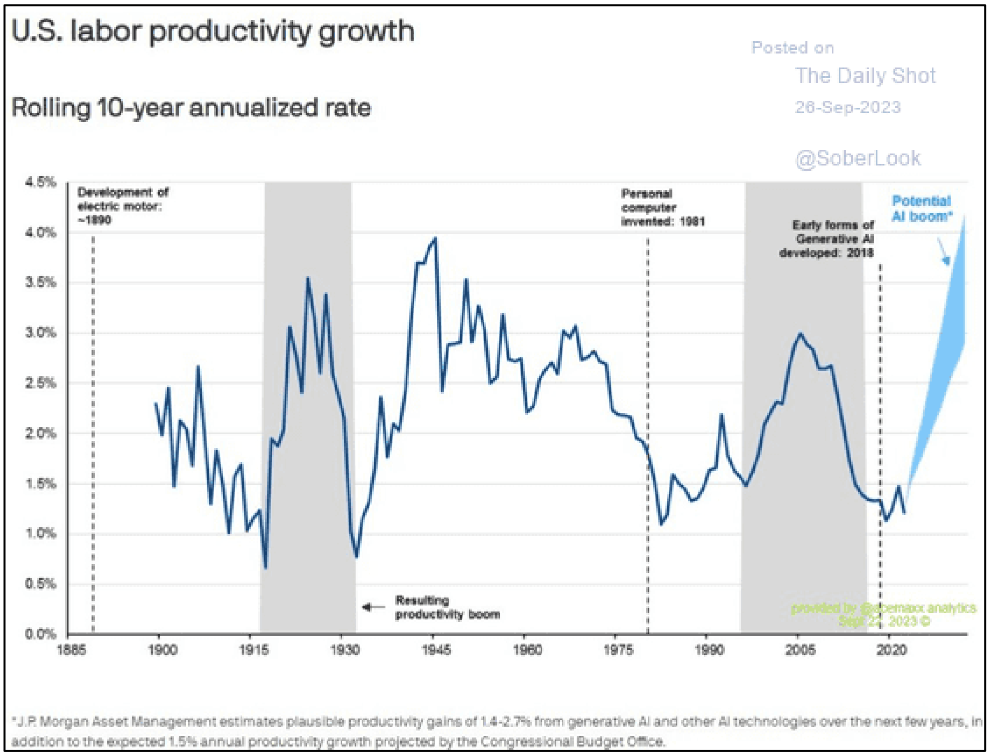
Rising interest rates retard the value of nearly every financial asset... but we have made one investment not subject to the gravitational pull of interest rates: the California carbon allowances we discussed in our January 2022 quarterly letter[6]. Depending upon your situation and investment objectives, you may see this investment in your account in the form of an exchange traded fund, with the symbol KCCA[7].

While we have taken measured actions to respond to the new paradigm of higher interest rates, it is good to keep the larger picture in mind. The big money is made by remaining invested over the long term. It is over this longer term that we think artificial intelligence (AI) will usher in a new era of productivity improvements. We don't believe this will come so much from individuals using Chat GPT directly, but more

[6] See the discussion starting on page 8 at https://www.knightsb.com/2021q4

[7] Some of our investors have exposure to private investment vehicles which allow more efficient exposure to this emerging asset class.

from companies starting to use AI to make operations more efficient. Over coming decades, we expect AI to drive productivity and corporate earnings growth from behind the scenes.



The more we can get the machines to do work for us, the cheaper it will be to get work done, the more work will get done, and the more things we will have. This is how our society has generated increasing wealth for centuries, and the way to take part in this wealth creation is to stay invested over the longer term.

As always, we appreciate the vote of confidence you place in us when you invest your money alongside ours.

Sincerely,

John G. Prichard

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

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