Knightsbridge
WEALTH MANAGEMENT

July 12th, 2023

Summer Quarterly Commentary

"To go beyond the bounds of moderation is to outrage humanity. The greatness of the human soul is shown by knowing how to keep within proper bounds. There are two equally dangerous extremes- to shut reason out, and not to let nothing in."

Blaise Pascal (1623-1662)
Mathematician, physicist, inventor, philosopher, and theologian; co-inventor of probability theory

In this letter, we'd like to review some predictions from our 2022 year-end missive published this January[1]. In that letter we said that inflation was plummeting, and we were likely to have a recession, but equity returns could still be healthy going forward because of the damage inflicted in 2022. We probably deserve a B-. Inflation is down but hasn't completely disappeared and we're still waiting on the recession. However, the healthy returns arrived faster than expected.

In June, the benchmark S&P 500 Index reached 20% above its October 2022 low, signifying the end of the bear market that started on January 3, 2022. Technically, a new bull market has begun. The first half return for the vaunted index was an impressive 16.9%, an historically notable figure even for a full year. This is quite the performance in an environment where many investors were worried about higher rates and a possible recession.

[1] Available here: https://www.knightsb.com/2022q4

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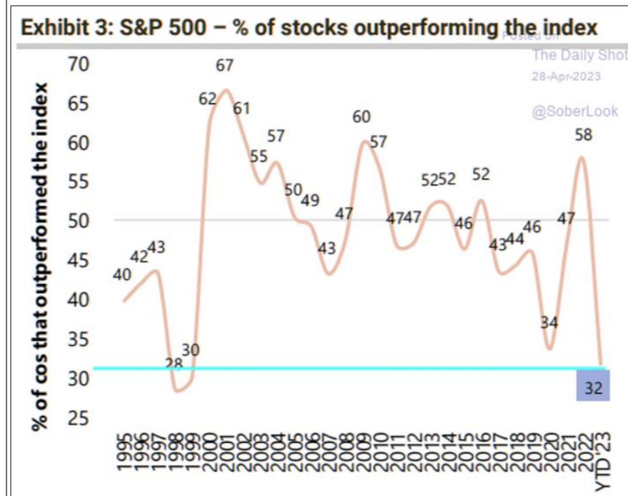
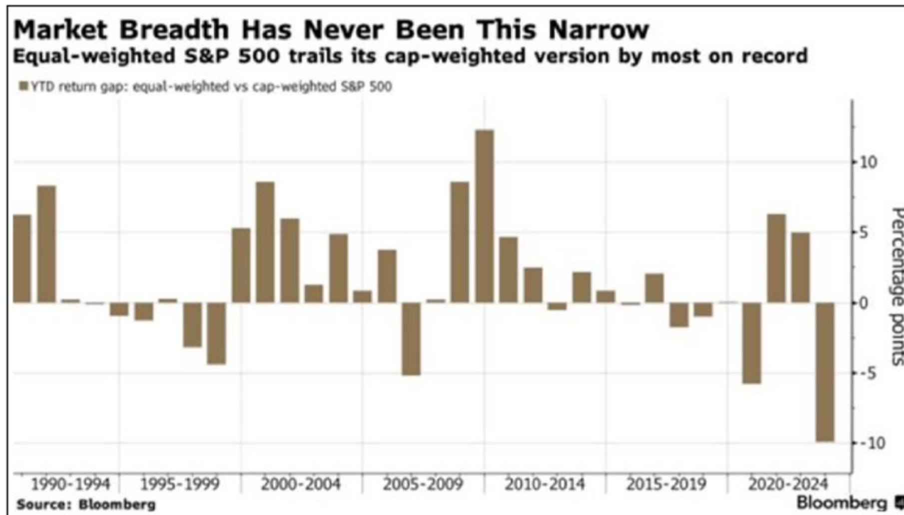
Truthfully, that headline return masks much of the story... it hasn't been a raging bull market for everyone. The index performance has been largely driven by a handful of tech companies, the so-called Magnificent Seven (Apple, Microsoft, Alphabet, Amazon, NVIDIA, Meta, and Tesla). These stocks now make up a whopping 28% of the index and are responsible for the lion's share of year-to-date gains. One result is that an impressive (depressive?) two-thirds of the stocks *in* the S&P 500 are underperforming the index this year.

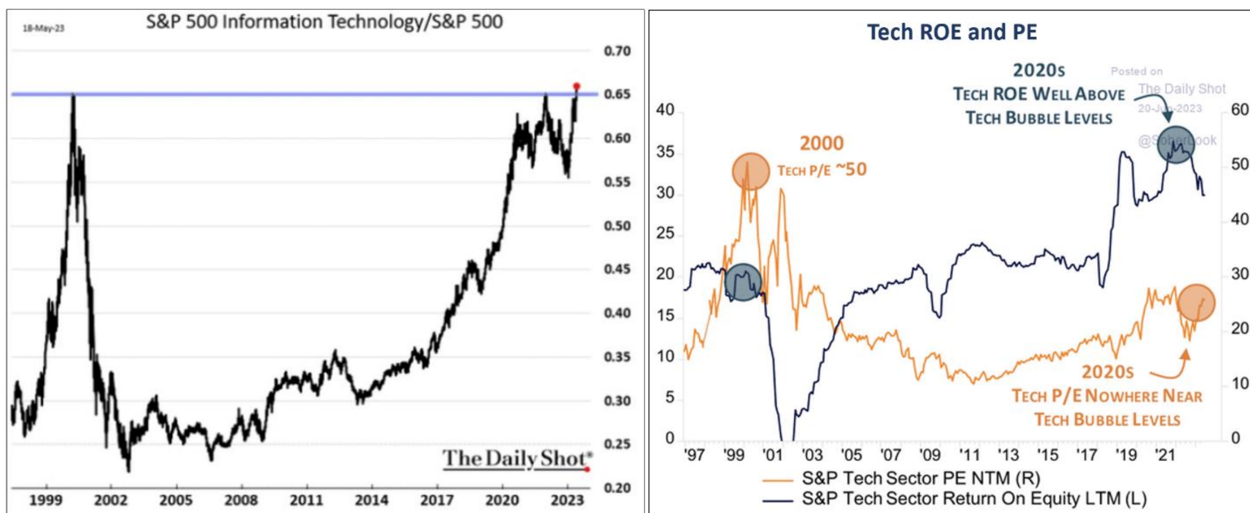


One might think that at any given time, half the stocks in the S&P 500 are outperforming the index and the other half are underperforming it. That's not true for two reasons. First, stocks with greater overall value (market capitalization) are weighted more heavily. The larger the company, the more significant its contribution to overall index movement. Synchronized moves among the largest company stocks can dominate the index. Secondly, the stock market is often led higher by upside outliers[2], which can pull the average up and leave everyone else trailing behind. Both of these factors have been acting in concert thus far in 2023, which makes the present situation extreme. This is perhaps best evidenced by how the S&P 500 Equal Weighted Index (more indicative of the "average stock") trailed the standard cap-weighted version by the most on record.

[2] Outliers in a grouping of stocks usually pull the average up, not down. After all, stocks can go up a magnitude of any percent. They can only go down 100%.

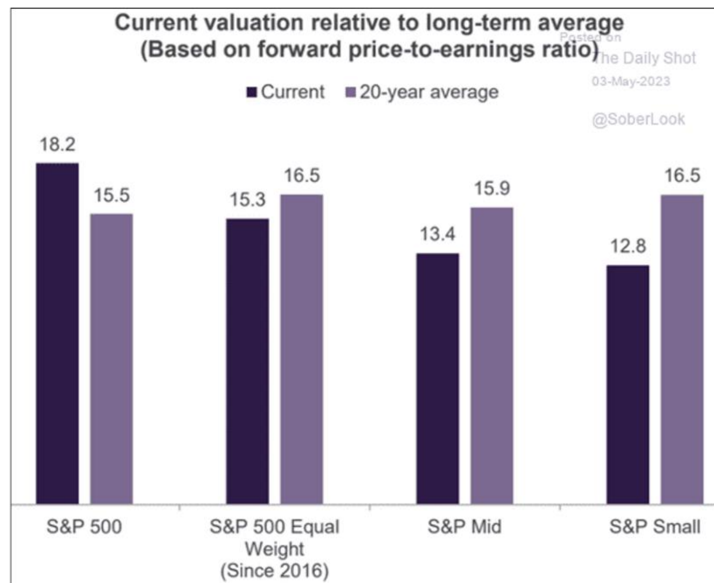


The total dominance of large cap tech stocks is reminiscent of the dot com bubble, but there are important differences. Back then it was all about hype, all about the future of what the internet *could do* someday. Today, it's about what the internet *is doing.* While many of these stocks are too expensive for our taste (NVIDIA trading at 40 times annual revenue comes to mind), the valuations aren't as extreme as they were in 1999. The underlying businesses have mostly solid profitability and quickly growing revenues. Today's tech stock valuations might be high but they're not yet wacky.

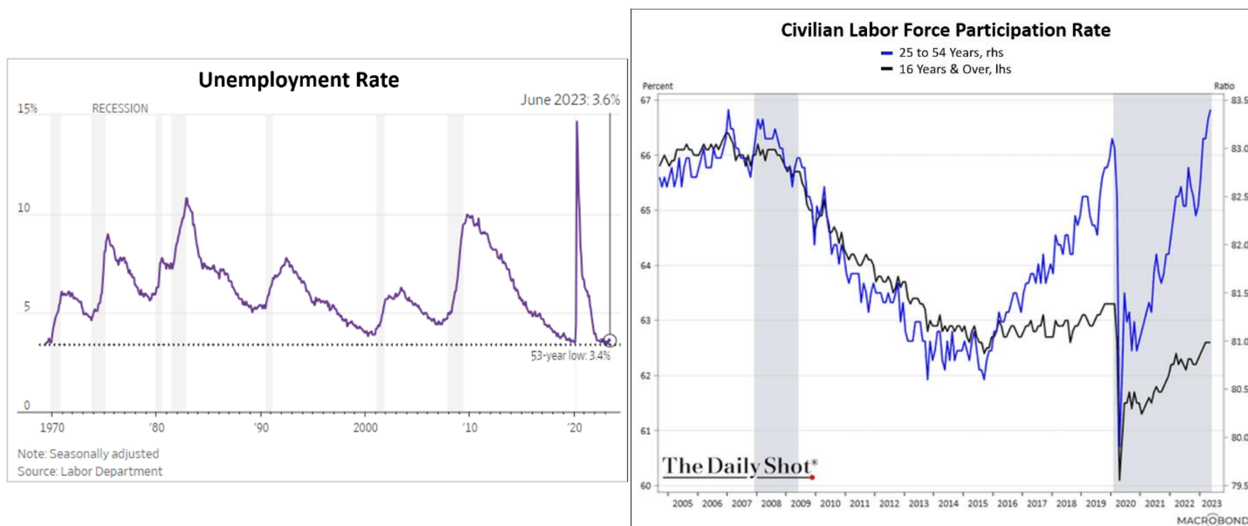


Our active Opportunistic Value Equity strategy mostly stays within the bounds of the S&P 500, and we've been fortunate to have enough winners to stay ahead of the index for the second quarter and year-to-date. Small and medium company stock indexes, however, are devoid of the anointed few highfliers, as are both foreign developed and emerging market stock indexes. For this reason, all of them are trailing the S&P 500. We have exposure to these indexes in our broader equity strategies. This diversification beyond the S&P is prudent in our minds because not all

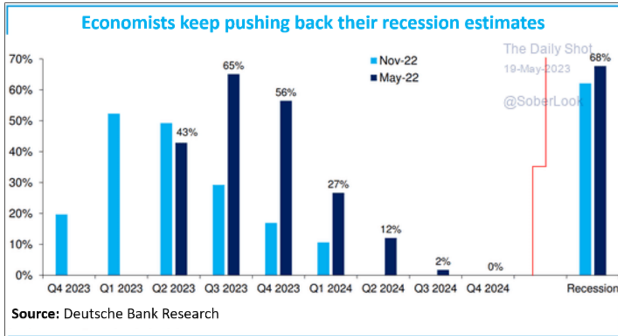
years will look like this one; the situation could easily reverse in the future. Smaller company and foreign stocks are cheap compared to their large cap S&P 500 peers, potentially setting the stage for a rebound.

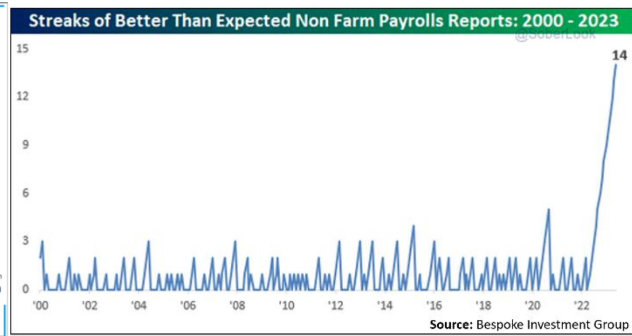


Part of the reason stocks have been rising is that the recession we were calling for in 2023 has yet to surface. Quite the opposite; the economy has been strong despite all expectations. Unemployment is low and not because people aren't looking for work. Prime Age labor force participation is all the way back to where it was in 2007, let alone pre-pandemic[3].



[3] Careful observers will note the chart shows that the over 16 labor force participation is still low. This is partly due to an aging population that naturally retires but also due to the wave of age 55-65 early retirements that happened during and post-Covid.





The above charts show how economists have been persistently wrong in forecasting an imminent recession. They keep pushing back their estimates of when GDP growth will turn negative. More strikingly, economists have also just had the longest streak on record of *underestimating* the number of employed people in the next "non-farm payrolls" report.

Returning to our predictions from six months ago, we also noted that inflation had all but disappeared for a moment and that might represent a trend going forward. At the time, the November inflation reading annualized to 2.4%. Well in the seven months since that last reading, inflation[4] has clocked in at an annualized pace of 3.1%[5]. This is of course above the Fed's 2.0% target, but to us not all that frightening. Others, including the Federal Reserve, apparently disagree and conclude there is still much work to be done on the inflation front.

They and others interpret the strong economy and "elevated" inflation to mean that inflation will be difficult to tame, necessitating rates that are "higher for longer". Indeed, longer-term interest rates (best shown by the 10-year U.S. Treasury rate) recently popped back up above 4%.

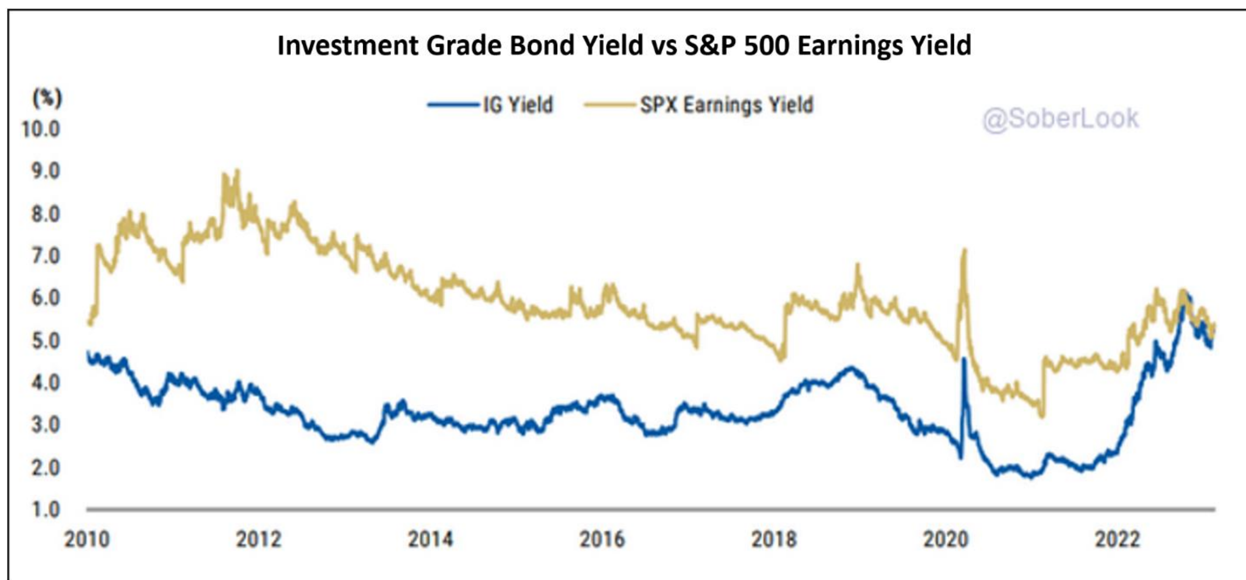
[4] The measure quote here is for the standard Consumer Price Index (CPI). Many other measures of inflation exist. Some economists, including those at the Fed, are concerned over higher "services" measures which exclude the falling costs of goods.

[5] The just released annual rate came out at a similar flat 3.0%

Where rates are headed is unknown, but they're higher for now and this has several implications:

1. **Banking issues will likely return. We wrote in our last letter that while specific banks have specific issues, the underlying problem for banks is that higher interest rates reduce the value of their assets. That is now happening again.**

2. **Bonds are better investments than they used to be. Fixed income investing is coming off a brutal stretch with the benchmark Bloomberg U.S. Aggregate losing about 11% over the last two years. Our Managed Income strategy has done a better job of protecting client money, and again is outperforming in 2023. Fortunately, fixed income returns, both in general and for Managed Income, are likely to improve going forward for two reasons. The first is straightforward - bonds now produce more meaningful income. The below chart compares the earnings yield of the S&P 500 (earnings / price) to investment grade corporate bonds. For the first time since the Great Recession, they are in line with one another[6].**



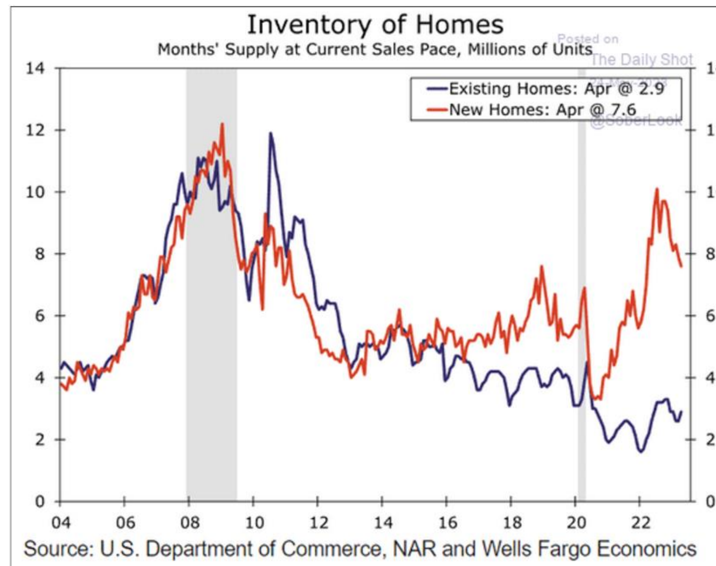
The second reason prospects for the bond market appear vastly improved is related to the first. Now that interest rates have lifted off zero (and are possibly peaking), they have room to fall. Any decline in rates would raise bond prices and reverse some of the damage from the last couple of years.

[6] Stocks, however, are likely still better for most long-term investors because their earnings will, in all likelihood, rise over time whereas the interest on a bond is fixed.

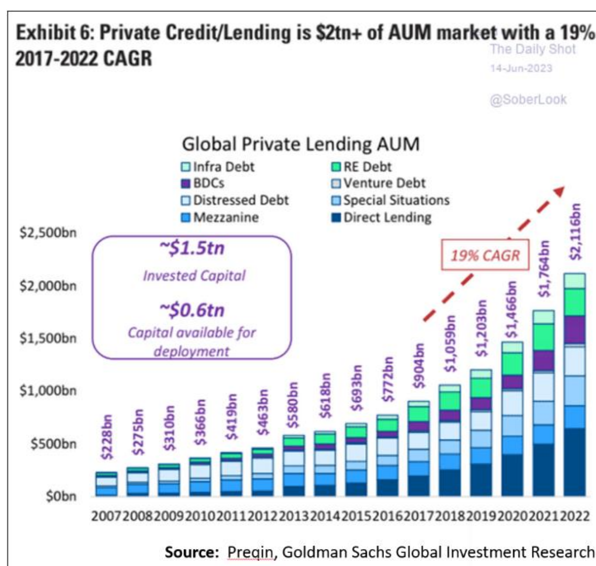
3. **The housing market will be locked up.** **Mortgage rates have just returned to their highest levels in a decade. This is terrible news if you're trying to buy a house. But it's not that bad if you already own a house *and* have a fixed-rate mortgage. Lucky you if you're in that second group[7]. Unfortunately, if you have that great low-rate mortgage, you can't take it with you when you move. We're seeing this in the data. No one wants to relocate because they can't get nearly as much house for the same mortgage payment. Thus, the inventory of existing homes for sale is extremely limited. With hardly any existing homes on the market, homebuilders have less competition for their limited inventory of new homes for sale. As a result, they are thriving despite the rise in mortgage rates and the anticipated accompanying decline in home values. We recently purchased a home builder in our Opportunistic Value Equity strategy based partially on that thesis[8].**

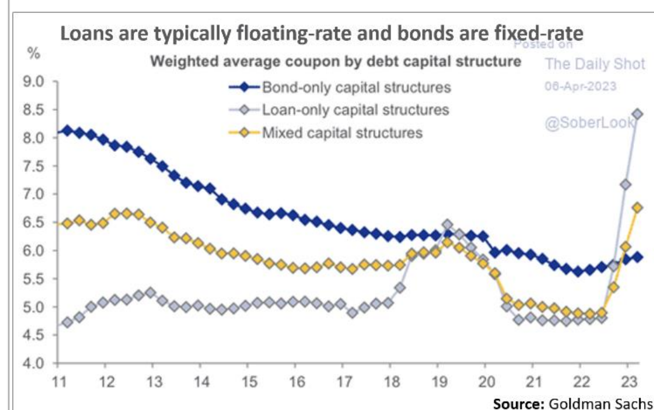
[7] If you have a 30-year fixed rate mortgage, then you have an unbelievable financial advantage courtesy of the U.S. Government's involvement in the mortgage market. (They have encouraged that mortgage type.) Most mortgages in Europe are floating rate, and homeowners there have seen their monthly payments go up. In Canada, usually when the interest rate goes up, the payments don't... homeowners just get more and more payments tacked on to the end of their schedule.

[8] Another rationale behind the purchase is that the homebuilding industry was decimated in the aftermath of the 2008 financial crisis. Since then, our country hasn't been building nearly enough homes for our growing population. We expect homebuilders to continue fixing that problem and profit while doing so.



Higher interest rates obviously impact the debt markets, but they don't do so uniformly. An interesting facet of the U.S. debt market is that private market debt is mostly floating rate while public market debt (i.e. publicly-traded bonds) is mostly fixed rate. Fixed rate debt doesn't immediately benefit when interest rates increase[9]. Rather the opposite, its value declines until those fixed interest payments offer the same yield that is available elsewhere. This is why the past few years have been exceptionally tough for bond investors. However, for holders of private debt, when interest rates rise, the *value* of their debt doesn't change at all, because the payments go up. This is a nice feature! Hence, while public debt markets have been decimated, private debt markets have continued delivering positive returns. Guess where all the new money has been flooding? Into private debt markets.





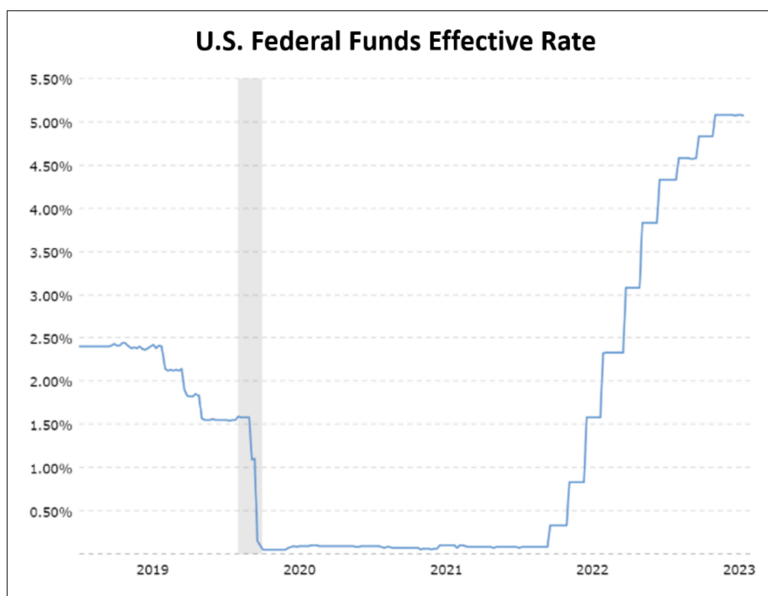
[9] Eventually, fixed-rate debt investors benefit when their old loan is repaid and they get to make a new one at a new higher rate.

Yet, even in private floating-rate debt markets someone does get hurt when rates rise. While the lenders are happy, the *borrowing companies* must pay more. Behind the scenes, this new, suddenly higher debt burden is squeezing private borrowers and could cause repayment issues. Private debt investors appear unscathed for now, but that may not last as the higher debt service starts challenging the underlying borrowers[10]. For that reason, we are somewhat hesitant to join the rush of investors into the private debt markets.

This same dynamic is at play in the private equity space. Private equity managers buy companies and then load them up with debt... *floating-rate* debt. These companies are now suddenly burdened with higher interest expenses. This means less money to reinvest in the business, and ultimately less money to pay out to private equity investors. Verdad Advisers recently reported that interest costs at the median private equity-backed company in their dataset had risen to 43% of EBITDA. Our friends in private equity similarly report that their companies are often paying double the interest they were a year ago.

New financial innovations have made it substantially easier for smaller investors to get involved in the previously difficult-to-access private equity market. We have been looking at these opportunities for you, our clients. However, similar to our views on private debt, we think there could be another shoe to drop and intend to be patient before risking your money in that arena.

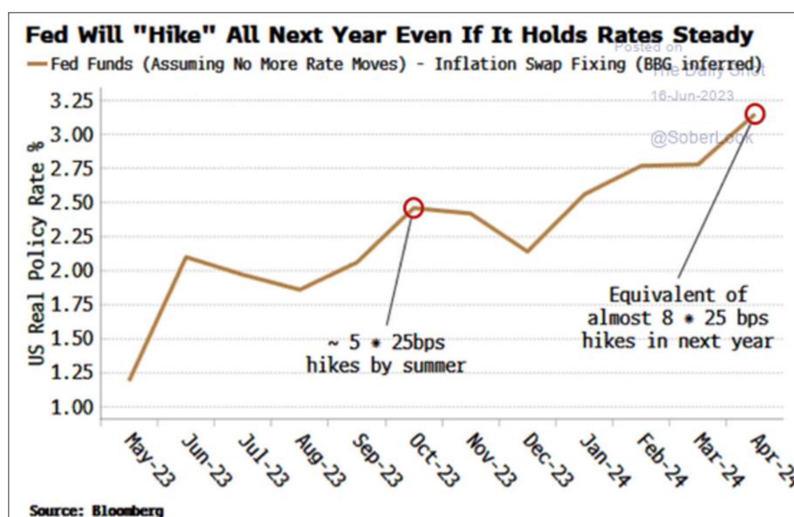
To return to our previous topic, we're not so sure the U.S. economy is bulletproof and rates need to stay that much higher for longer to bring inflation to heel. Just one year ago the Federal Reserve still had short term rates at 1.58%. Today they are at 5.08%.



[10] Fixed rate borrowers will face payment issues as well when their existing loans mature and they have to borrow again at higher rates.

Financial markets (especially the bond market) felt these effects very quickly, but the real economy did not. It is commonly accepted among monetary wonks that it takes an entire year for interest rate changes to be fully felt in the real economy. Furthermore, the 1.58% rate present a year ago was very low by any historical measure. An argument could be made that interest rates were still exerting a *stimulative* effect during the move from 0 to 1.58%, because those rates were still below where they'd be in a normal environment[11]. Thus, the economy has yet to feel the full effects of the change from 1.58% to 5.08%, which represents the entire movement into economic tightening territory.

There is still yet another reason that past interest rate increases will only continue to bite harder: falling inflation. This is because it is the gap between the interest rate and the inflation rate that really causes the tightening. The wider the gap, the tighter financial conditions become. Thus, as inflation continues to fall, even the present level of interest rates will continue to slow the economy more and more.

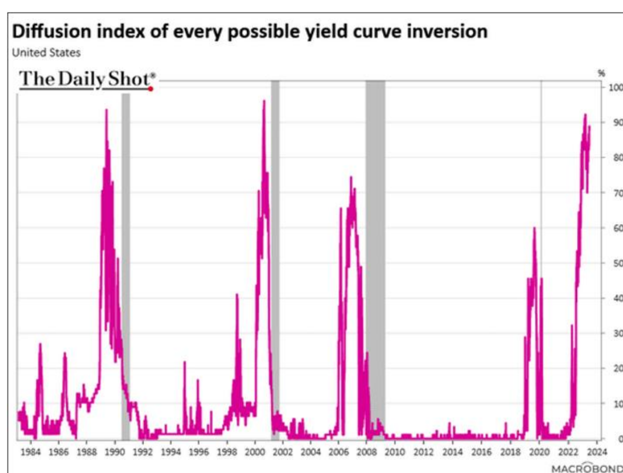


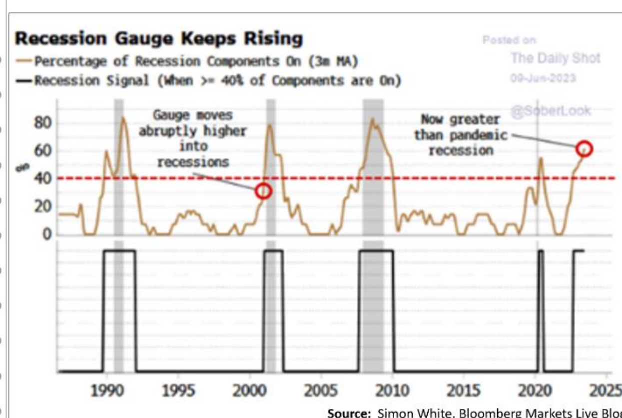
When you realize that increases in short-term interest rates continue to affect the economy for an additional year after the increases stop (especially since inflation is already falling), you come to another conclusion. In order to calibrate the level of interest rates "just high enough" to control inflation, you have to stop raising rates while inflation is still higher than you'd like it to be. Nevertheless, the Federal Reserve has indicated they are highly likely to increase rates again at their next meeting, with potentially a few more hikes after

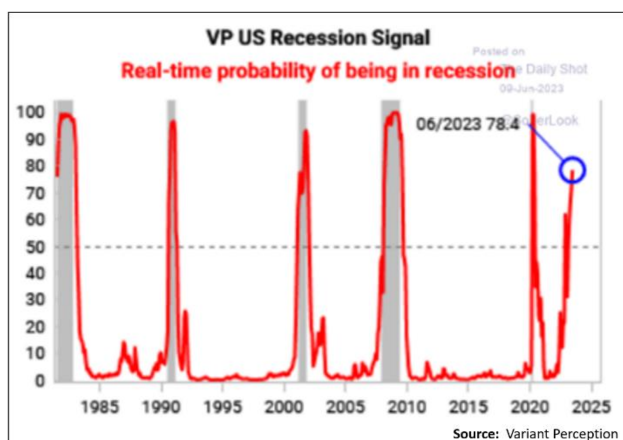
[11] The formal way to say this would be that 1.58% was still below the so-called neutral rate. The neutral rate is the hypothetical level of interest rates where they would have neither a tightening (restricting) nor a loosening (stimulative) effect on the economy. No one can observe what the neutral interest rate is, but economists do try to estimate it and most estimates are above 1.58%. Thus, from this viewpoint, monetary tightening has only taken place during the last twelve months. Anything before that (from 0 to 1.58%) was just less easing.

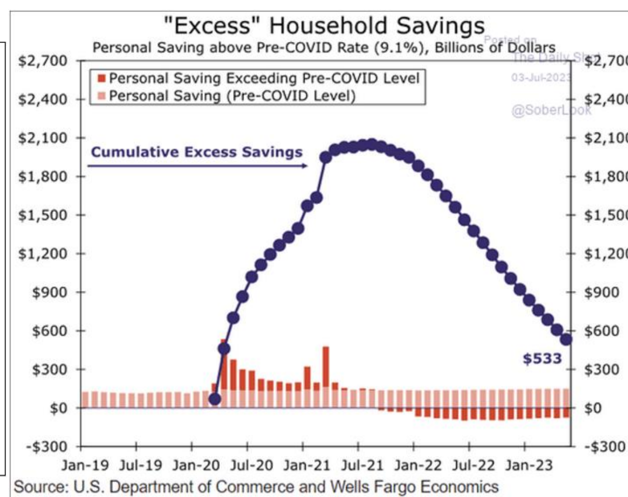
that. We think the Fed is running the risk of overdoing it and causing a recession after all.

Put another way, perhaps the recession we and others have forecasted isn't cancelled, but rather just delayed. The yield curve is still inverted. Leading indicators are still screaming red. If the administration finally makes good on its promise to resume student loan payments in October, more than one trillion dollars of debt will suddenly require payments again. The result will be additional money subtracted from millions of bank accounts, thereby lowering discretionary spending, reducing economic activity, and consequently easing inflation. The same goes for the excess household savings generated during the Covid era: it is nearly extinguished. When it's gone, inflation, spending, and GDP are all likely to decline.

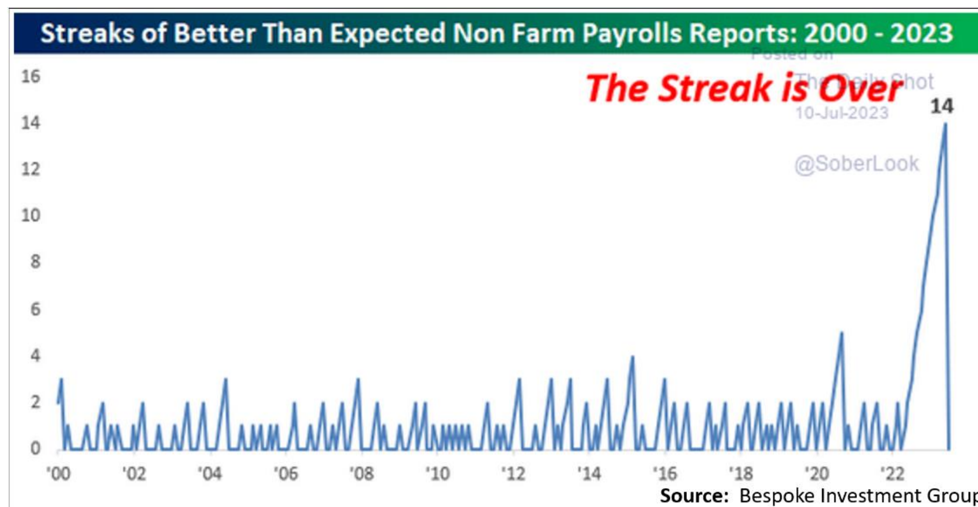








Perhaps we should be wary in rejoining the chorus predicting economic contraction, knowing that many keep getting it wrong[12]. On the other hand, remember earlier when we wrote about how payroll (employment) reports kept coming in better than economist predictions? That streak was broken during the writing of this letter. Maybe we deserve better than a B-.



And yet, there is always something to worry about. We are not hitting any panic buttons. Whatever the economic future holds, we remain at the helm, patiently and prudently seeking to maximize your wealth, alongside our own. We appreciate the opportunity to do so.

Sincerely,

John G. Prichard — **Miles E. Yourman**

Kurt Beimfohr — **Jeff Vieth**

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[12] To be fair, if the Fed changes tack and holds rates steady or preemptively lowers them, we just might end up with that soft landing (where inflation recedes without a recession) after all.