Monthly Depth Report – December 2022

Improved Policy at the Fed – Does This Mean Victory for the Squirrels?

Longtime readers know my view on travel, and I'm happy to report that I'm writing this letter from Thailand. To make money in the stock market, it helps to see things differently from the consensus view. While I've always been wired to have an alternative point of view (just ask my parents), there's something about the stimulation of being in different places and dealing with new people, different cultures, and language challenges that spark my creative side. By breakfast on my first day here, I had a list of ideas that led to multiple posts over the next few days, a flurry of Twitter threads (@Gary_Brode), and to my thoughts on this letter.

Have the Squirrels Taken Over at the Fed?:

We've been having a bit of fun at the expense of central bankers the past few months noting how they constantly expand debt and debase the currency during good and bad times while squirrels and my former pet gerbil, Stevie, understand the need to save during good times so they can enjoy that excess during the lean times. It does seem that the Fed has gotten serious about trying to fix prior policy problems.

After four giant 75bp (.75%) rate hikes, Fed Chair, Jerome Powell, is now signaling a coming 50bp increase. The market acted like we're getting ready for a return to zero interest rates and endless quantitative easing (money printing), but **Powell's comments weren't as dovish as the market seemed to think**. He and other Fed Governors have made it clear that they're slowing the rate of interest rate increases because the economic impact lags policy changes by a few months. However, **the new mantra appears to be that the Fed intends to raise rates to a level higher than they had previously indicated and hold them higher for longer**. The "pivot" to lower rates is still not close. **Powell has even made it explicitly clear that he's prepared to put**

the economy into a recession if necessary, but will not under any circumstances, let inflation run rampant.

DKI has been highly critical of the Fed for more than a year and we pointed out that inflation was huge, understated, a big problem, and not "transitory" in November of 2021, long before Powell acknowledged the Fed was slow in responding. At this point, we'd like to offer praise for the Fed deciding to take the real problem seriously. While a recession will be incredibly painful for many families, it will be better in the long-term than too-low rates leading to massive inflation, more asset bubbles, and continued mal-investment. Interest rates signal to the market the price of time and risk, and getting that signal wrong means more wasted capital that could be used to create real jobs, growth, and prosperity. Inflation is a hidden tax on savers that amounts to theft. This tax lands disproportionately on families with fewer financial resources.

DKI has also been critical of the Fed's obscene $9 trillion balance sheet which includes trillions of dollars of mortgage-backed securities it's not permitted to own. Earlier this year, the Fed said that months down the road, it would accelerate the reduction of the balance sheet (quantitative tightening or "QT") to $90 billion a month. While that sounds like a lot, it amounts to $1.1 trillion a year which isn't much against the then-current $9 trillion balance sheet. Wolf Street points out that the Fed balance sheet is now down to $8.6 trillion with reserve balances down $1.1 trillion. Reserves refer to the cash that banks store at the Fed overnight, and those institutions and their customers are looking for higher yield than is currently available at the Fed.

Our conclusion is that the Fed balance sheet is still too large and that real interest rates (the fed funds rate less the rate of inflation) are still negative. That means that the situation is still pretty bad; however, Powell and the other Fed Governors are taking steps to address the issue and address prior errors. The alternative hypothesis is that the squirrels have actually taken over the institution. Either way, we're starting to get better policy.

One other positive note here is that the labor market remains strong. In recent weeks, the market has focused on a slight uptick in unemployment claims and a small downtick in job openings. However, there are still 10MM unfilled jobs in the US and the labor participation rate is still well below pre-pandemic levels. The implication is that employers are going to need to offer higher wages to bring in people who are currently on the sidelines which means we could end up with more inflation later.

Last week, we got an incredible report showing over 260,000 new jobs created vs an expectation of 200,000. In addition, wage growth is now over 5%. While great for the newly-employed and those who received raises, this report does indicate that we're going to see continued inflation especially on the services side of the economy. Our prediction is and has been for a recession, but we remain encouraged by the current strong labor market.

Update: As I was in the process of writing this, we received some new economic data. Recent spending growth was higher than expected and core personal consumption expenditures came in a little low (more discounting?). Spending growth was higher than wage growth which means consumers are reducing savings and taking on debt which is good for DKI stock pick Enova International (ticker: ENVA). So, the economic picture isn't completely clear, but there's no question that high employment and wage growth (future inflation) means people are spending. One possible explanation is a continued lower demand for goods and a continued higher demand for services.

Las Vegas Sands and Energy:

I've been following Las Vegas Sands (ticker: LVS) since 2014. While much has changed over the years, one part of our most recent thesis on the stock, was our belief that the Chinese government would approve the re-tendering. This means the company would be permitted to continue operating in Macau past the 2022 deadline. Last week, we got the official recognition that LVS has succeeded in the re-tendering effort, and the expectation of that success combined with the recent confirmation has been a large part of the stock's move over the last five weeks from $35 to $48 making this a profitable trade for DKI subscribers. We're hoping that recent protests in China succeed in getting the government to allow more freedom. This is a human-rights issue, but for the purposes of our investment thesis, a more complete reopening of the Macau casinos would be good for our investment thesis as well.

DKI has written extensively about energy all year. First, we correctly thought oil was a good hedge against inflation. Recently, we've focused more on the supply/demand imbalance in the energy markets. **We recently wrote a lengthy piece outlining our view on the sector which is available to subscribers here. For the non-subscribers who are interested, we are currently offering your first month free so you can check it out risk-free by clicking here.**

The Sell-Side STILL Has It Wrong:

The sell-side analysts at the big Wall Street firms are famous for adjusting their estimates and ratings **after** the news is already announced. At that point, you can get the same value from reading the newspaper. I'm including a brief section from a DKI premium post published on November 30th because we think earnings estimates for 2023 are still too high:

> *We've been clear in pointing out that the sell-side analysts at the big Wall Street firms are not predicative; but rather, are great at telling you what happened after it's happened. In fact, their business model is based on NOT trying to make you, the investor, money. If you want to understand this issue in greater detail, we've laid out the case here.*

Earlier this week, the Wall Street Journal wrote about the sell-side expecting more than 5% earnings growth for the S&P 500 in 2023. The same article also said that investors were waiting for Fed rate hikes to bring down earnings at which point, the analysts would lower estimates. ***DKI has been telling you for half a year that earnings estimates are too high and need to come down. The sell-side is waiting for companies to report poor earnings, AND THEN they'll lower their "estimates".***

The takeaway: Estimates are too high which is why we've kept the market short in place. Also, independent research is valuable to investors while the sell-side is trying to make money from their investment banking clients.

Two Lessons on Investing from Thailand:

While I haven't been in Thailand long enough to have much in the way of valuable observations to offer at this time, the trip here did provide a couple of valuable investing lessons. I flew Qatar Air through Doha on the way. The flight staff was friendly and hospitable and proud of the fact that Doha is hosting the World Cup. I had noticed that the flight attendants were serving alcohol on the flight, and had read about the limits on alcohol at World Cup events.

The western press tends to present the issue as one of Muslim repression. When I asked the Qatari flight attendant about this, he said that Doha is a fun place with many bars and clubs where alcohol is legally served. He explained that the government prohibited alcohol sales in the stands during games because they didn't want people from other countries to get drunk and start fights. This is a very different explanation than the one we've seen in the western press.

While I have no idea which of these stories is true (and acknowledge that both sides may have some elements of truth), it leads to an important point on understanding the stock market. For each stock, and for the market in general, there is always a dominant narrative. Often that narrative is correct. However, any time this happens, there is a tendency towards groupthink where market participants simply accept the story they're told. **In these moments, there is an opportunity to make great returns if you recognize that the dominant narrative is false, and you have a well-researched alternative hypothesis. Deep Knowledge Investing exists to find those opportunities.**

The second observation came from watching the Michigan / Ohio State football game on my flight (The Game). As a Michigan grad, I was excited to see if Michigan could knock off their highly-ranked undefeated rival for the second straight year. Michigan has a dominant ground game so in response, Ohio State brought their entire defense up to the line of scrimmage on most plays. This is a daring strategy because it means that Ohio State had a numbers advantage on every play; however, it also meant that any mistake meant there was no help behind the front-line defense.

Here was the result: On 80% of plays, Ohio State held Michigan to just over 3 yards. That's great for Ohio State. On the other side of that, Michigan had touchdown plays of 69 yards, 75 yards, 75 yards, 45 yards, and 85 yards. The final score was Michigan 45 – Ohio State 23: A blowout win for Michigan.

For those of you who are wondering what this has to do with investing: **This example illustrates the importance of risk control. An investing strategy that works 80% of the time and gets you annihilated the other 20% is a bad strategy.** It's important not only to be right most of the time; but also, to ensure that your losses don't wipe out your entire portfolio. More observations on the stock market and Thailand coming next month!

<u>Time to Wrap it up for This Month:</u>

We'd like to thank you for reading this letter and to welcome our new subscribers. November was by far the best month DKI has ever had for adding new clients. Much of that is due to the support the firm has received from Michael Gayed of Toroso Investments. He was kind enough to include me on his Lead Lag Report Twitter Space (available here).

DKI has a partnership with Toroso Investments (@leadlagreport on Twitter). **If you're a financial advisor with more than $50MM under management, please reach out to us so we can arrange for you to get a premium subscription to Deep Knowledge Investing at no cost to you through Toroso.**

If any of you have questions, concerns, or thoughts regarding issues we should address in a future depth report, please feel free to reach out to me at IR@DeepKnowledgeInvesting.com. If you think a friend, RIA, family office, or portfolio manager would be interested in this monthly commentary, please feel free to pass it on to them.

Thanks for being part of Deep Knowledge Investing,

Gary Brode