Monthly Depth Report – January 2023

The Big Government Edition – Plus Risk Control in Thailand

I'm writing this on Christmas day while flying back to New York from Thailand. Spending a month traveling around Thailand was a fantastic experience, and I continue to believe there is tremendous value to embracing the stress and friction of living a different life in a new location complete with exposure to other languages, cultures, and people. More on that later in this letter. As usual, we start with finance.

Emperor Powell Pronounces the Market is Broken – Do You Know What to Do?:

I'll admit to copying this from one of our "Five Things to Know This Week" posts, but it sums up the situation concisely.

The CPI is announced, and the market lurches up or down based on what people think the Fed will do. Sales and employment data come out and the market gyrates based on Fed expectations. Powell speaks and people hang on every word. This is what happens when government policy and central banks take over an economy. There is no price discovery. There are no company fundamentals. There is just an Emperor, and we all wait to see if he'll favor us with low rates and quantitative easing or frown upon us and hike and tighten the money supply.

The DKI Takeaway: As a firm which extols the value of free markets and free people, we think this is a ridiculous way to run an economy and a stock market. **As a firm which is endlessly creative and adaptable, we've stayed months ahead of economists and sell-side analysts to make money for DKI subscribers based on the exact issue described above**. If you're looking for some help – just let us know.

Japan Throws in the Towel:

I've spent the past two months speaking in public and writing about the problems Japan is facing. The country has a debt to GDP ratio of 260% and has been trying to hold interest rates around zero. Money has been fleeing the country in search of higher yields, and as a result, the value of the yen has plummeted this year. That's generally a problem, but it's a huge problem for a small island nation with few natural resources.

This month, the Bank of Japan finally cracked and started to raise rates. This caused US markets to fall as more people are beginning to realize the debt trap governments have set for themselves during a decade of ultra-low interest rates and trillions of quantitative easing (money printing). The huge problem for Japan is with so much debt, they're now facing higher interest costs. They can either cut spending, raise taxes, or print more yen. The first two probably get their politicians thrown out of office so our prediction is for more yen printing. That will lead to more inflation and either further devaluation of the yen, or higher interest rates. Play that out for a few rounds and you'll see why it's called a "death spiral" and why we've been writing about a possible sovereign debt default. For those of you who want to understand this important issue in more detail, we have that covered here, here, here, here, and here. And for those of you who enjoy a little financial humor (please note that we posted this 9 days before the BoJ capitulated):

Gary Brode
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In today's financial analysis from Thailand: It looks like business at the ratings agencies is so weak they've started rating hostels. Even worse, at double b, we'd give this hostel an 85% probability of still being a going concern when Japan has a sovereign debt default

7:24 PM · Dec 11, 2022

China Throws in the Towel:

After nearly three years of insane lockdowns which included welding people into their apartments without food, medicine, or ability to escape in case of fire, the Chinese government completely abandoned its Covid-zero policies. Within a couple of weeks, we've seen reports of hundreds of millions of Chinese people contracting the virus. There are credible projections estimating that a billion people there will get Covid in the next couple of months. The good news is most of those people will make a full recovery and do so relatively quickly.

Macau, where Las Vegas Sands (ticker: LVS) has most of its assets, has been mostly closed for the past three years. It's now reopening for business, an event I admit I thought would have happened sooner. As of this writing much of Macau is now sick, but once the Chinese recover, Macau will finally be back in business. We note that when Las Vegas re-opened after the much shorter US lockdowns, it quickly started realizing record gaming revenue. With three years of pent-up demand, we expect the Chinese people will quickly return to gaming.

We also think China's reopening will increase energy demand. Energy prices have been generally lower the past couple of months as people are expecting a recession in the US and Europe among other places. We agree with those expectations but think renewed Chinese demand will take up some of the expected slack. There will also be additional demand from replenishment of the US Strategic Petroleum Reserve which is positive for our energy positions. Details available to DKI subscribers here.

Investing Lessons from Thailand and Risk Control:

One of the most valuable parts of living in a new culture for a time is certain quirks of a place become more obvious. For me, those tend to be in the areas of risk control. One thing I saw constantly in Bangkok were motorcycles weaving in and out of the city's terrible traffic. They'd even drive on sidewalks or into oncoming traffic as if in a videogame or bad action movie. Many of them wore a facemask, but not a helmet.

I think they're focused on the wrong risk. The probability of getting Covid while riding alone on a motorcycle is approximately zero, but the probability of a head injury while driving into oncoming traffic without a helmet is high. I also saw the same with young children riding in the back of a pickup truck on the highway. There is no chance of getting Covid driving 70 miles an hour in the back of a pickup on the freeway. But getting rear-ended without seats or seatbelts isn't going to end well.

All of this reminds me of a trip to Tulum, Mexico two years ago. I was swimming in a cenote when my guide suggested I approach a live crocodile for a photo. (A cenote is a sinkhole filled with water, not a type of soup as some readers have suggested.) When I declined, my guide asked me why. I responded that it's because crocodiles are very "bitey" animals. Trying to goad me on, my guide said, "but it's a once in a lifetime opportunity". I immediately responded, "that's exactly what I'm afraid of". Think about it: The best-case scenario is I'd have a photograph documenting poor decision making. That's not winning!

Last month I highlighted the poor decisions made by the Ohio State defensive coordinator in their football game against Michigan noting that any strategy that works most of the time but ends in disaster some of the time isn't a good idea. That applies to wearing a helmet when riding a motorcycle, getting eaten by a crocodile, and in investing.

Investing Lessons from Thailand and Perspective:

For me, the best part of traveling is the people I meet along the way. A couple of weeks into my trip, I found myself in a fascinating and friendly conversation with JJ, a local who spoke excellent English. When I asked him about his language facility, he told me he was from the

Philippines. That makes a lot of sense as due to the US military presence there and the educational system, young people from the Philippines tend to have excellent fluency in English. We spoke about that for a few minutes when he said something about the US colonizing his country.

It's very important in these moments to remain curious and not become defensive. I encouraged him to explain his thoughts further by noting that no one I knew in the US considered the Philippines a colony; but rather, thought of his country as an ally. He responded that the US saved the Philippines from Japan which was a terrible occupation. He felt gratitude for that. I don't think he felt anger at the US, but it was on his mind that after saving them, we didn't leave. It's a valid and interesting perspective, and one that was new to me. JJ and I parted with a warm handshake and kind words for each other.

Here's why this matters: Last month, I wrote that these moments provide an important point for 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.***

<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. I've just finished a four-part series updating all subscribers on our view on the markets, the federal reserve, and what we think will happen next. It's a great introduction to DKI, and a refresher for long-time readers. Most importantly, at DKI, we're willing to go on the record with clear explanations complete with how we're positioning our portfolio for what our analysis predicts.

Much of our recent growth 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 to discuss a possible Japanese sovereign debt default which was timely and is 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