Monthly Depth Report – November 2022

Stevie the Gerbil vs Jerome Powell – You Vote!

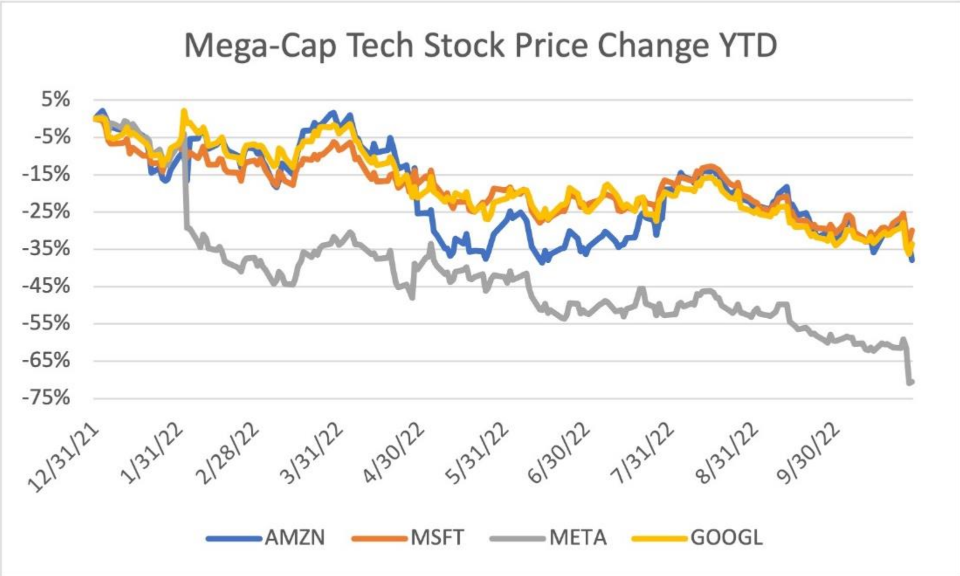
Last month's letter titled, "The Squirrel Who Lives in My Backyard is Smarter Than All the World's Central Bankers Put Together" was our most popular one yet which indicates that DKI readers are very smart and understand that the market should set interest rates rather than a group of unelected bureaucrats who have never run a business. Alternative hypothesis is DKI readers really like rodent-related content.

Who are we to argue? As a result, we will be featuring prominent rodents in finance for the 4th quarter, and this month we ask whether Federal Reserve Chairman, Jerome Powell, should be replaced by Stevie the Gerbil. As usual, finance first, interesting gerbils later.

Earnings:

As I write this, we've seen the first couple of weeks of 3Q earnings. The first week went fine, and then the mega-cap tech stocks reported. It didn't go well. Revenue was weak in the online ad space and growth is slowing in the big cloud divisions. Expenses were up as well. **We think the weak results from these huge companies indicate the economy is in worse shape than the White House and the Bureau of Economic Analysis would have us believe.** (More on that last point later in this letter.)

Stocks on the DKI recommended list had great quarters. Two companies beat and raised guidance. Another is seeing a post-Covid recovery. And the energy companies we own are all having a great quarter and year with several posting record results.



It's not just the quarter. It's been a bad year for these companies.

Energy:

It was a wild month where politics and energy intersect. Last month, someone blew up the Nordstream Pipelines with enough explosives to register on the Richter scale. Then, the White House asked Saudi Arabia to increase production through the midterm elections. The Saudis recognized this as an election-related request rather than one tied to the energy markets and declined. Instead, OPEC decided to cut production by 2MM barrels per day. Congressional Democrats are now threatening to withdraw troops from Saudi Arabia which would leave a power vacuum to the benefit of Iran, would drive the Saudis to a greater partnership with Russia and China, and would break the petrodollar agreement reached by Kissinger and the Saudis in the 1970s. The White House has since reached out to terrorism-sponsor, Iran and communist dictatorship, Venezuela to try to get more production from them.

At the same time, both the White House and the State of California chastised domestic companies for lack of production and high prices while threatening a "windfall tax" on US-based oil companies. **The same people who are complaining about lack of production have said publicly they want to put the energy companies out of business. As a result, no one is building refining capacity which is where the real shortage is in the US.** The Commodity Trader in Chief is even putting a $70 floor on oil prices. Trading commodities is difficult even for people who do it for a living. The White House does not have the expertise to do this. The US needs a better energy policy, and if you'd like to understand this important issue better, we have written clear analysis here. Update: As I'm writing this, the White House just threatened US oil companies with more taxes if they don't "invest". We've looked into the issue with former White House advisors and current Congressional staffers, and it would be difficult to enact legislation on this.

Economic Data:

The September CPI came in higher than "expected". At this point, we can't imagine why anyone is still reading the forecasts of people who have been consistently wrong all year. Energy prices are rising again, and real estate transaction prices are just starting to come down on low transaction volume. The big story is that services inflation is still high and sticky. We continue to make the point that food inflation is undercounted, and shelter (housing) inflation is intentionally understated. We believe the real rate of inflation experienced by most Americans is currently in the mid-teens. More detail on that here.

The 3Q GDP report was back to positive after two negative quarters. The problem with the report is that the inflation adjustment was only 4.6%. Imagine that a baker makes a loaf of bread this year and charges a dollar. Next year, the same baker could bake an identical loaf and charge two dollars, but economic activity hasn't actually doubled. Cutting through the finance here, if your household expenses are up only 4.6% in the last year, you might believe the recent GDP report. **If your expenses are up much more than 4.6%, you might join DKI in**

being skeptical of the official number. As always, government numbers do not reflect reality; but rather, are created by government employees to advance a preferred narrative.

Update: While in edit, we got a large increase in the number of jobs available. This indicates that labor cost inflation which primarily affects services is unlikely to come down. It also makes an eventual Fed "pivot" to lower rates more challenging.

<u>Bonds Were Not Cheap:</u>

At the beginning of October, we published a piece titled "Questioning the 'Bonds Are Cheap' Narrative". Many market participants were claiming at the time that bonds were cheap because they've declined in price substantially during the year. We posited that bonds simply went from insanely-expensive to somewhat-expensive. The TLT (20 Year Treasury Index) was down an additional 14% in the month which is a huge move in what is historically not a volatile market.

Update: While this letter was in edit, the Federal Reserve enacted its fourth straight 75bp rate hike, and Chairman Powell made it explicitly clear that he wasn't done raising rates. He further explained that the "terminal rate" (the rate at which the Fed stops its rate hikes) would be higher than expected as recently as September. **DKI has been positioned all year for higher-than-expected inflation leading to higher-than-expected rate hikes leading to larger-than-expected market declines. At this point, we're not sure why investors continue to read "analysis" from large sell side firms who have been consistently wrong.**

<u>Stevie the Gerbil vs Jerome Powell:</u>

Now we come to the hero of this month's letter. Many years ago, I had a pet gerbil named Stevie. She was a sweet pet who loved to be held, and had several characteristics that we think would make her an ideal replacement for Fed Chairman, Jerome Powell. We'll evaluate the two candidates on three separate challenges, and let you decide who should run the Federal Reserve.

First Round:

At the time I was dating someone who was studying to become a nutritionist. She decided that Stevie should have more fresh produce, so put her hand in the cage and offered Stevie a cherry tomato. The little gerbil hopped up, sniffed the tomato, and hopped away. Later, I saw another tomato offering. I asked why she was offering Stevie the tomato again when it clearly wasn't of interest. My girlfriend said that when you give a child food they don't think they'll like, you need to offer it three to five times for the unappealing item to be accepted. The second attempt went the same as the first one with the tomato offer being calmly rejected. That evening, my girlfriend went back for a third attempt. This time, Stevie hopped up, sniffed the tomato, and bit the girlfriend's finger. Apparently, Stevie had decided she was done with the whole tomato in her cage nonsense and needed to communicate that more clearly.

Recently, we've seen entreaties from long-only money managers begging Chariman Powell to stop raising interest rates. Cathie Wood even wrote a public letter to the Fed warning it's risking an economic "bust". Wood's flagship Ark fund is down 60% this year and 76% from its all-time high. So, we're a little skeptical that she's just concerned about her fellow citizens and not just "talking her book". So far, the Fed has ignored these pleas and has been raising rates more aggressively than other central banks.

Verdict: Both Stevie the Gerbil and Fed Chair, Powell are willing to resist nonsense and bite back. Score after one round: Stevie 1 – Powell 1.

Second Round:

Stevie loved to bang her running wheel against the side of the cage and eventually, flip it on its side. I'd come by, figure she'd want to run later, and reposition the wheel. Five minutes later, I'd be walking through the living room, and Stevie would have flipped the wheel again.

Chairman Powell kept rates around zero for a long time after inflation was an obvious problem, and was part of the decision to let the Fed balance sheet get to $9 trillion in assets including trillions in mortgage-backed securities that the Fed isn't allowed to own.

Verdict: Both Stevie the Gerbil and Fed Chair, Powell like to make a mess. Score after two rounds: Stevie 2 – Powell 2.

Round 3:

My nutritionist girlfriend decided to make another attempt at getting Stevie to eat more vegetables. When cleaning out Stevie's food dish, she replaced the normal dry crunchy food with mixed fresh vegetables. Stevie hopped in the dish as usual, and immediately exploded out like there was a grenade hidden in with the carrots and peppers. I walked by the cage a few minutes later, and Stevie was happily crunching on dry food. It turns out that every day, she'd hide much of the food we gave her in case of emergency. In this case, emergency was defined as being fed vegetables.

Stevie can enjoy some delicious dry food now, and save for a future shortage. Future Fed Chair?

Verdict: Like the squirrel we highlighted last month, Stevie the Gerbil was able to foresee a potential future shortage, and prepare for an emergency situation (or just a temporary shortage). Our Federal Reserve (with the assistance of massive Congressional overspending) has debased our currency, and made it clear they're willing to crush the economy to avoid having to cut spending. In other words, they will spend the income from many tomorrows to keep the party going today even though it leads to disaster. Score after final round: Stevie 3 – Powell 2.

It's clear to us that Stevie the Gerbil (and any animal who can save today to manage through future shortages) is a better choice for Fed Chairman than the current occupant of the position. Feel free to email us at IR@DeepKnowledgeInvesting.com to let us know your vote. Winner gets to be Fed Chair next.

Time to Wrap it up for This Month:

People are understandably concerned about markets that no longer even attempt to try to weigh the fair value of a company. The stock and bond markets shouldn't be driven by the day-to-day announcements and decisions by a group of unelected central bankers. **DKI's point on this matter remains that you have options other than being 100% long all the time. We've helped our subscribers get better returns including and especially this year when conditions have been challenging for a lot of people.** If you'd like to know what I'm doing in my portfolio to handle the current situation, feel free to reach out. Alternatively, we're currently offering a free month to new subscribers so you're welcome to just give DKI a try.

Recently, we began a new 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

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