Monthly Depth Report – October 2022

The Squirrel Who Lives in My Backyard is Smarter Than All the Central Bankers in the World Put Together

Ok – I know what you're thinking: Let's skip the finance and get to the interesting part about the squirrel. No chance I hand over the good stuff at the beginning and lose the audience one paragraph into this letter. Finance first – squirrels later.

There were three key events that happened in September. First, inflation was higher than the market expected leading to bigger than expected interest rate hikes, and subsequent market declines. Federal Reserve Chairman Powell spoke with unusual clarity in late August and September about being focused on reducing inflation. None of this was a surprise to Deep Knowledge Investing readers though. We warned that inflation was huge and not transitory last November, and shorted multiple market indexes in early January on this exact thesis.

Then, despite raising rates and engaging in quantitative tightening, the Bank of England announced the purchase of 30-year gilts (the UK equivalent of a Treasury Bond). This is quantitative easing. The next day, markets rose as the "pivot" people got excited about the return of the zero-interest rate party. They thought the central banks would restart the money printers. A day later, the markets fell as the story came out that the reason for the BoE bond purchases was to bail out the pension funds. The concern was the funds were going to fail due to swaps positions that were effectively leveraged bets on perpetual low (zero) interest rates. Your takeaway from this is that one of the oldest most established markets in the world almost collapsed, and that no one has learned anything from 2008.

Finally, last week, someone blew up the Nord Stream pipelines that transport gas from Russia to Germany. This act destroyed billions of dollars of valuable energy infrastructure, and can easily be interpreted as an act of war. NATO promptly blamed Russia, but we're skeptical of that answer. Russia can (and has) shut off the gas flow at their own discretion, and the pipeline was a useful piece of leverage for when European citizens become furious at the insane heating costs they'll be facing this winter. We'll be updating our energy portfolio for subscribers shortly.

Reading the above, it's clear that the people in charge of things have no idea what they're doing. At the most basic level, the finance behind all of this is simple. People have the option to spend everything they make, or to live on less than their income, and save the rest. Those savings can become investments which make life better, more efficient, and more pleasant for all of us. Any society that doesn't save and invest will simply live on a subsistence income as they watch their infrastructure crumble around them.

Despite the obvious signs of extreme financial stress, Congress continues to overspend by trillions each year, and the Federal Reserve continues to monetize that excess debt. We're living on more than we produce, and are printing dollars to make up the difference. This is not a sustainable system, and rather than fix the problem when it became apparent to everyone in 2008, we've spent the last 14 years pursuing the exact same policies – only bigger. It's the real-life version of the Max Power way.

This brings us to the hero of this month's letter. I typically spend most weekend mornings reading for work. In the fall, I'll often take a few hours to watch the Michigan game on Saturday. A few years ago, during my fall Saturday routine, I noticed that a juvenile squirrel was spending 5-6 hours at a time running along my fence and jumping into a tree for a long climb to get a nut. Squirrel would race back along the fence, jump down the wood pile, and disappear to store one more nut for winter. This was a Rodent of Unusual Character (but relatively small size).

The following year, Squirrel had a squirrelfriend. (It's like a girlfriend, but with a bushy tail.) He spent that fall collecting nuts and running along the fence as usual, and she'd be bouncing along behind him also carrying a nut. They were a lovely couple, and the following spring, there were two baby squirrels including baby girl squirrel who was very cautious. She'd climb a tree slowly always keeping three points of contact.

This spring, I had three baby squirrels in my yard, almost certainly the grand-squirrels of Squirrel. Unfortunately, one of them was taken out by Cyrus, the hawk that guards my fence line and hunts in my yard.

Over the last couple of weeks, I've noticed one of the new squirrels following in grandad's exact footsteps. He's racing along the fence, climbing a big tree, and coming back with his nut…hours at a time.

Despite some losses due to cold and predators, this squirrel family has prospered because they work hard when times are good to save for when times are bad. They're not capable of building more efficient nut gathering machinery, but despite being incapable of investing like humans, they're doing well.

Alternatively, every major central bank in the world is doing the opposite: constant deficit spending (good times or bad), artificially low interest rates, quantitative easing/buy everything possible. This behavior is debasing the currency and creating inflation. This plan has been the ruin of every empire for thousands of years, and these central bankers act like they are incapable of learning lessons from financial history which they should study and know prior to taking on positions of national responsibility. If we were to replace every single central banker with the squirrels from my back yard, the system would work better. At a minimum, with a squirrel in charge, we wouldn't require emergency action to prevent the entire pension sector from imploding.

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.

Last month, 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