October 2023

If you'll recall last year's stock market, only after three horrendous quarters did the stock market have a grand "reflex rally" that began in late fall of 2022. It did not have much in the way of fundamental underpinnings to it, but it felt great! Yes, it had momentum as it was a bit of a technical rebound from the -35% lows that we saw in tech stocks during the summer of '22. There was a lot of positive sentiment and emotion, or as we've discussed in previous monthly investment letters, "**FOMO"** - fear of missing out. Everyone loves a bullish narrative, but it was all centered around the "Magnificent Seven" mega-cap stocks only. As I mentioned in an earlier investor letter, the other 493 stocks in the S&P 500 have been flat ever since! The contrarian in me is why I have been a bit conservative for most of this year despite all the positive externalities that we had been witnessing within the markets up until August. But the fact is, there really are no good fundamentals or proper valuations underpinning this year's market. I've been more focused on real world facts, statistics, and observations such as;

- The Leading Economic Index (LEI) has fallen for 17 consecutive months as economic uncertainty continues to grow in the US economy.
- The ISM manufacturing purchasers managers index (or PMI) which has been in contraction for the last ten months in a row and has basically been in decline since March of 2021 at the height of COVID.
- Delinquency rates on credit card loans have soared to 11 year highs and that is before we begin to factor in the effects of student loan repayments which are set to begin again this month. I fully anticipate further loan delinquencies and bankruptcies.

Some of the other data points that have piqued my interest;

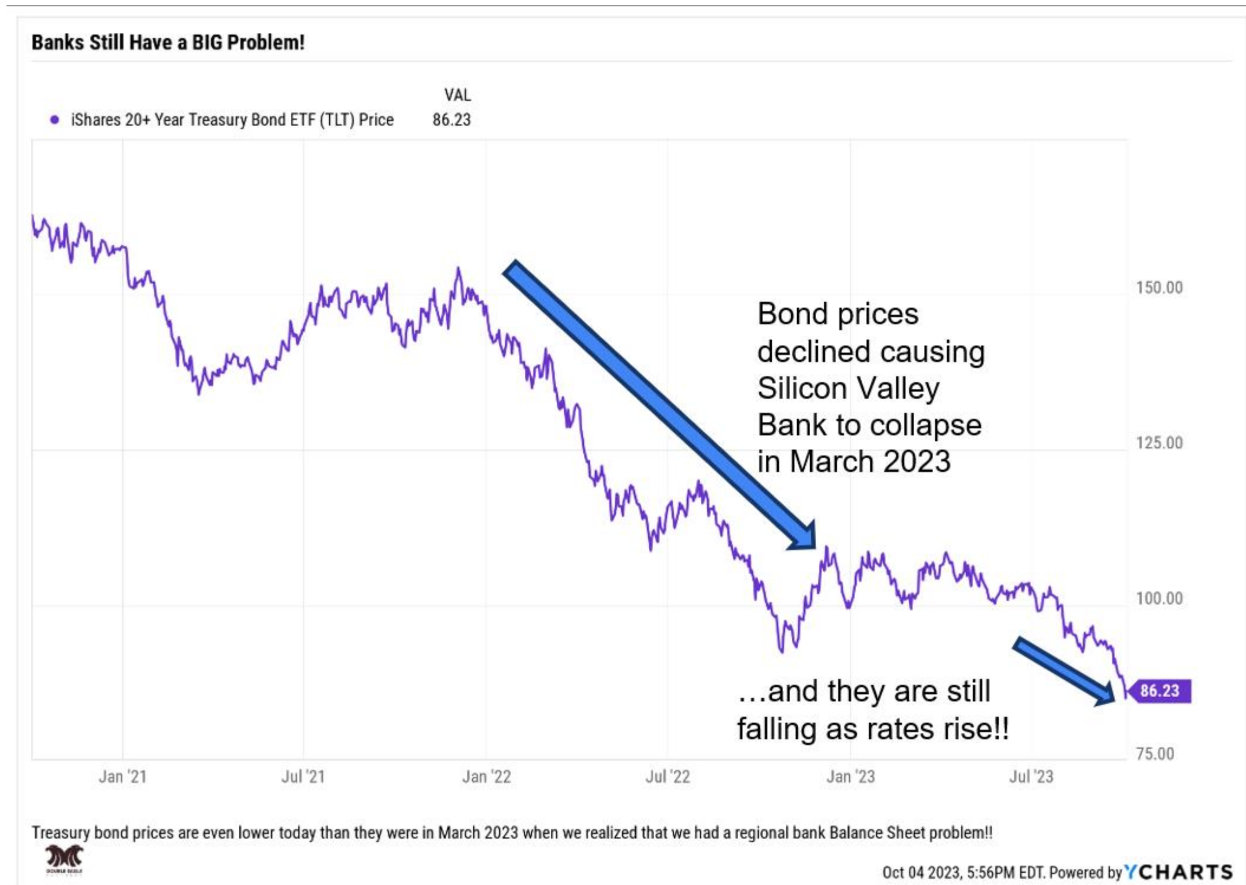
- the 30-year U.S. Treasury bond is currently yielding 5%. This is the highest interest rate for 30-year bonds since 2007.
- Residential mortgages have hit 8%, which is the highest mortgage rate since 1996. Combine that with the highest home prices we've ever seen and housing affordability in United States is abysmal.
- Oil prices have been going up steadily all summer, as a matter of fact they're up 33% since June. This will eventually flow through to gas prices at the pump which will have a slowing effect on the global economy. And demand for oil is not going to slow down even if we get the coming

recession because the United States government is going to have to replenish our Strategic Petroleum Reserves (SPR) which have been drained by the Biden administration to help contain gas prices this year. The SPR is in the precarious spot of currently only having 17 days of oil supply in case of a national emergency, the lowest level since it was created in the 1980s. This is untenable and will need to be replaced soon, regardless of the price of oil (the Biden administration had said that they were waiting for oil prices to come back down to $60 per barrel before they would refill the SPR…good luck with that).

All this empirical evidence and yet Chairman Jerome Powell of the Federal Reserve and Treasury Secretary Janet Yellen still are predicting that we are going to have a "soft landing". The rate of inflation may be slowing (disinflation), but prices are not coming down (that would be deflation). Spoiler alert: prices are still going up albeit at a slower rate than they were earlier this year.

My two biggest concerns about the recent sharp rise in long term interest rates and widening budget deficits are concerning the sustainability of our U.S. government to incur these increased borrowing costs, that and the health of regional bank balance sheets holding this government debt. You see, as interest rates rise the interest costs that the US government has to pay on all this increased borrowing needed to finance our debt goes up, becoming a bigger and bigger proportion of our government's budget. Currently, our biggest government outlays are Medicare / Social Security and the US military. But in a close third is the cost of servicing the interest on our debt. This may become unsustainable as interest rates continue to rise and these costs continue to rise.

My other concern is what happens to the balance sheets of our banks holding these bonds. When interest rates go up, bond prices (value) go down. You will recall from my podcast in March of this year Silicon Valley Bank, Signature Bank, Silvergate Bank and First Republic Bank all went bankrupt or had to be bailed out because the bonds that were held on their balance sheet (mainly U.S. Treasuries) were no longer worth what they had originally valued them. As you can see from the chart below bond prices had been steadily declining for the better part of a year before Silicon Valley bank went bankrupt. These banks, along with many others, were bailed out when the US Treasury & FDIC instituted a new repo program to take some of these devalued assets off of their balance sheets at 100 cents on the dollar as collateral for a FDIC loan so they could continue to operate. But as you can see from the chart below, prices have continued to decline since March of 2023 and are now at the lowest levels in 20 years. This bank balance sheet problem is only going to get worse in the coming months, especially if the economy enters a recession. This may be the straw that breaks the camel's back and causes a larger financial crisis in 2024.



You may recall from some of my earlier investor letters this year, I explained that we were going "back to the future" where we would have higher interest rates for longer, and that seems to have come to fruition after the latest FOMC meeting. In my May 2023 investor letter, I explained the ramifications of an inverted yield curve which usually predicts an impending recession. And my August 2023 investor letter reiterated the axiom "Sell in May and go away". This has proven to be a very fortuitous move for our portfolio performance over the last quarter.

Here are **four reasons** why I continue to have some trepidation with regards to this market going forward;

1. **The spike in inflation has been damaging to the consumer**. While it may have slowed its pace of increase, it is not coming down anytime soon.
2. **The inverted yield curve, which has been going on since July of 2022, has not reversed itself** but has continued to invert. Right now, you can buy six-month U.S. Treasury bills yielding 5.5% or you can buy 30 year treasury bonds yielding 4.90%. With all the uncertainty in this economy, where would you rather park your money?
3. **There has been an unprecedented rapid rise in interest rates**. Per the chart below, as interest rates go up, bond prices go down, there's an inverse relationship. Since the United States

economy was operating with near 0% interest rates for so many years over the last decade, we have become addicted to “free money.” Not only has our population become use to to 0% interest rates on car loans and 3% mortgage rates, but corporations have been gorging on low interest rates for years to help them leverage their businesses. The US government enjoyed borrowing costs near 0% for many years over the last decade as well. Now with the spike in rates, the bills are coming due, and the economy will slow down as a result.

4. **Big oil price shock**. As I mentioned earlier, oil is up 33% since June of 2023. This rapid rise in oil prices has yet to fully been recognized at the pump (unless of course you live in California where you're regularly paying more than $7 per gallon.) I do not foresee oil prices coming down anytime soon. Between the supply side being squeezed by OPEC and the demand side being backstopped as the United States replenishes the strategic petroleum reserve, I fully expect oil to hit $100 a barrel and continue to move higher over the coming year.

We were fortunate that our US economy came out of the global financial crisis in 2010 and rebounded throughout the Obama and Trump years. COVID stimulus spending and extremely low interest rates basically masked any financial imbalances that were going on within our economy for the last three years. These financial imbalances only came to light when growth faltered and interest rates started to rise. As Warren Buffett has often said; “a rising tide lifts all boats, but only when the tide goes out do you discover who's been swimming naked.”

Fortunately, we at Double Eagle Partners are all wearing our bathing suits!

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