IN FOCUS

BEAR MARKET RUMINATIONS

THOUGHTS ON A BEAR MARKET, RECESSION, AND OTHER FINANCIAL DEVELOPMENTS

CAMBIAR INVESTORS

The goal of this piece is to articulate our thinking about the current state of financial markets globally and to provide some basic thoughts on where we sense an opportunity for patient investors. This is a global bear market, and bear markets are ugly affairs. It is an unusual one by modern standards, as Central Banks appear intent on causing financial instability as part of an overall effort to reassert inflation stability and Central Bank credibility around inflation and price stability expectations. These goals are either somewhat or highly contradictory, depending on your vantage point, and the potential for unintended consequences is high. Nonetheless, there is money to be made, sometimes considerable amounts, exiting bear markets, the fearful behaviors they incite, and the changes in conditions that bring them about and lead to their resolution.

We hesitate to call stock market bottoms or what precisely might change in finance that would presage a bottom. We suspect two variables, a cessation or top to interest rate increases in the U.S., and normalization/stabilization in economic activity outside the U.S. would probably help markets stabilize after a punishing first three quarters. Longer term, other features leading into the current bear market include a lack of realism about the state of geopolitics, what is and what is not prudent with respect to "efficient" supply chains, the de-carbonization transition, sensible and non-sensible sovereign governance, just to name a few. We can't possibly explore all these topics here but anticipate some resolutions, or at least better answers, are needed.

A quick glance at the sub-components of inflation year to date in the U.S. will show many variables poised to or already rolling over as supply/demand mismatches abate and fervent demand for financed products, such as housing, have dried up. Measures of fixed income and currency volatility have reached unusually high levels consistent with a major low. They can't get much more volatile than they already are. It would not be surprising to see a peak in "hawkishness" this quarter. A more predictable and less reactionary Fed would help the financial climate, but the impacts of a durably higher cost of capital for a global economy that had become very used to a minimal one should not be under-appreciated. Outside the U.S., realism has been in short supply, as China persists in its COVID-Zero policies, Russia continues in a war of annihilation in Ukraine that it did not plan for and does not appear able to win. Europe faces a challenging backdrop of deficient gas supplies following a misguided degree of reliance on Russia and intermittent renewable energy sources. We expect this trio of policies, supply deficits, and wars will exhaust themselves in some way, but not on a timetable that anyone could or should rely on. In other words, there is a basis for some optimism versus an abjectly pessimistic set of investor sentiment indicators, surveys, and positioning measurements, entering the 4th quarter.

BACKGROUND NOTES

Financial asset prices started the year with declines, which have persisted without abatement into the end of the third quarter. Bond prices, which have been inversely correlated with stock prices for most of the last 30 years, have provided no benefit and become highly correlated to stock prices. International asset allocation, once seen as a risk-diversifier, has been similarly unproductive, with international stock and bond valuations declining. Dollar-ized returns have been well worse, as most currencies have declined materially. These FX declines have accelerated explosively in September.

The primary cause of these declines is the (definitive) end of an extended period of historically low sovereign interest rates globally from 2008-2022 and the associated increases in capital costs and risk premiums for financial assets. This unusual period was a consequence of post-2008 Global Financial Crisis (GFC) economic conditions, and it seems, ended with changes in various economic conditions that the COVID-19 global lockdown brought about. The totality of circumstances is far more complicated than the previous sentence, but these two global crises neatly bookend the period of unusually low interest rates, capital costs, and low inflation that the world is now exiting. There are also numerous U.S. and global economic imbalances that have built up over this time period. These need repair and are fixable by markets and businesses. Free markets and the incentives created by price movements generally lead to new and durable equilibriums. We believe investors should focus on these ultimate outcomes. Partially offsetting this optimism, we harbor concerns that the abrupt end to an extremely long period of super low interest rates, which coincided with a time of limited conflict or disharmony among advanced nations that is also ending, entails further valuation risks and unappreciated sensitivities to higher capital costs.

FROM CREDIT-SCARRING TO ECONOMIC-SCARRING

Investors in 2022 are generally well-versed in the causes of the 2008 financial crisis, which included systematically poor credit standards, a variety of odd credit structures with incorrect credit ratings that served to mask the poor credit standards, and high systemic leverage in banks and financial institutions. All these factors led to *malinvestment* – too many houses, oversized mortgages, and too many people working to supply the excess of homes, lending products, and so forth. To prevent systematic deleveraging from causing an even worse economic calamity via deflation in a very financialized system, Central Banks took interest rates to 0% (or below), bought a variety of bonds, and signaled that they would keep at it, ergo subsidizing credit costs and blunting risk premiums in various assets. It worked, thankfully.

But that was a long while ago. In our view, Central Banks in the United States and abroad failed to normalize interest rates once the threat of a deflationary debt spiral and asset bust risks had passed (~2015-2017) and proceeded much deeper into risk suppression and rate subsidization during the pandemic. The deficiently low cost of capital, risk, and negative real rates of remuneration on savings have led to a different sort of malinvestment bubble than the housing and credit bubble of the 2000s. This includes an excess of startup and "disruptor" business ventures that are well capitalized and scaled but have yet to generate profits, too many service sector jobs, too much financialization of the real economy (still), overly optimized supply chains, inflated asset prices and related questionable investment fads, and likely unsustainable sovereign debt levels. Malinvestment bubbles also tend to divert resources away from where they ought to have been deployed. In today's world, this implies deficient investment in various basic and necessary physical products, infrastructure, and other productive capacities, leading to inflationary pressure and a slowed capacity to respond to price signals.

Making matters more complicated in 2022+ is the *economic scarring* that resulted from extremely disruptive COVID-19 lockdowns impacts in the USA and Europe in 2020-21, as well continued lockdowns in China and other parts of East Asia. In the post-housing crash 2010s, home construction workers found other things to do given poor employment and remuneration options. Once housing markets finally cleared from any remaining excess supply, the industry capacity to build new homes was greatly reduced (or *scarred*) in terms of skilled workers and related home construction materials. The U.S. could not possibly build 2 mm homes as it did in the mid-2000s. Likewise, airlines and airports shed vital workers in the depths of the 2020 lockdowns, having no visibility on when and in what form travel would return. It did, with a vengeance, but with fewer trained pilots, air traffic controllers, baggage handlers, etc. employed to handle a full return to 2019 volumes, as many retired or moved to new fields. We see similar *scarred-supply* effects in basic materials, energy, food service, transportation, health care, and industrials to name but a few of the many fields that were affected by the abrupt and nearly total shutdown of large portions of the physical goods and services economy in 2020. With skilled laborers scattered into other fields, the wages needed to draw them back into these necessary areas are high, leading to inflationary pressures to recalibrate capacity.

A deeply scarred supply side, coupled with a malinvestment bubble, and the reversal of many years of risk-premium suppression and capital subsidies, are a potent cocktail to digest. Markets are not taking the new and much more restrictive regime well.

SO WHAT HAPPENS FROM HERE?

First, it's important to clarify "here". The macro narrative at the end of 2021, renormalization of monetary and an end to post-GFC and Pandemic-driven policies, has rather suddenly morphed into a different and far riskier narrative of inflationary credibility and expectations control. Back in January, we had anticipated a challenging year given a building inflation problem and the need for monetary policy action/course correction by the Fed and other Central Banks. This scenario entailed increases in short-term rates to something neutral or restrictive over time, as well as balance sheet roll-offs, leading to a higher cost of capital broadly and increases in risk premiums for risk assets. Stock market multiples were likely to compress in the face of this. Higher multiple, high-duration, low-risk premium stocks faced a particularly large adjustment as the 0% cost of capital era ended. This entailed a value and low multiple stock market backdrop. The speculative fringe, disruptor, and short operating history stocks likely to lose a lot of value. Offsetting this, we anticipated a positive economic background globally given a protracted and still not fully reopened global economy at the end of 2021. Europe and much of Asia are still behind the United

States in terms of normalcy but inevitably to reopen and normalize.

That… is no longer where we are or where Central Banks are aiming. Beginning in June, Central Bank course correction became *reactionary* to exceptionally high inflation prints and uncomfortable increases in inflationary expectations. Corresponding Central Bank credibility took a hit. The result has been an aggressive series of rate increases to combat accelerating inflation expectations and regain the credibility narrative. Given the size and scope of fixed income markets, this more aggressive approach after such a long and docile period implies broad economic damage and the incurrence of considerable financial risks, in essence, for Central Banks to make their collective point. This change in behavior and intentional course is dangerous, and markets have correspondingly shed a lot of value, posting a variety of "worst since 2008" returns. Central Banks, led by the Federal Reserve, are following a decision to act somewhat irresponsibly over the 2015-19 and 2020-21 time periods, with a decision to tighten a very heavily financialized system at a reckless rate to reach a wholly unsustainable yield (i.e., continuing to act irresponsibly - just in a different 180 degree way) to atone for the prior instances. For now they are referring to this change in policy/management as "front-loading" rate increases.

No, we don't agree entirely with this playbook.

Credit markets are vastly larger than equity markets, placing immense weight on the cost of funding and impact on refinancing maturing debt. The world's stock markets equate to about $60 trillion of market value, down from closer to $80 trillion in January. Credit markets total closer to $300 trillion in principal, with an average maturity of about five years. As these vintages of loans and bonds mature and need refinancing, the cost of this year's aggressive Central Bank actions will accumulate. Simple math suggests a 200 bps increase in global average interest rates means a $6 trillion increase in credit servicing costs in a global economy of ~$100 trillion. This is a lot! That simple math won't be felt right away but speaks to the potency and magnitude of interest rate increases in a heavily financialized world with an immense stock of low yielding debt that will, eventually, need refinancing. This is a powerful reason why this year's Central Bank actions are highly likely to dampen global economies and subdue much of the inflationary pressure. Going extra high to a rate well above neutral (current dot plots suggest >4%) probably cannot be sustained by the global financial system absent an acute turn to chronically high inflation. This is a core reason why markets are showing increasingly high-stress levels across asset classes.

From a stock market perspective, this means growth stock multiples remain at risk and overall economic and financial stability are now in doubt. Lower multiple/lower expectations/higher risk premium stocks (usually these are value stocks) are also at risk in this crossfire. Notionally defensive harbors, such as food and beverage stocks, telecoms, utilities, and health care stocks face varying degrees of downside risk as well. Many companies in these sectors have limited pricing power and won't grow in line with inflation, face their own set of disruption risks or face mounting debt. A 2000s styled-defensive stock playbook does not seem to be in order. The "recession is coming" call has become so loud as to be a consensus in equity markets, via depressed multiples, and in fixed income markets, via a deeply inverted yield curve. Against such a background, we believe companies with low debt, low dependence on access to debt-financing, high pricing power, modest multiples (and therefore modest implied growth expectations), and clear end-market opportunities into the next cycle are the best options in an admittedly small strike zone of opportunities.

We would prefer not to play the "sector overweight/underweight" game, as such sentiments can quickly be transposed into multiples and expectations, thereby limiting the opportunity set. Deep in a bear market, it is mostly about weighing relative-opportunity sets and being mindful of when outright giveaways are taking place. That said, based on our views and prevailing current market prices, we are leaning in the following directions:

Industrials - A variety of productivity-enhancing industrial businesses should benefit from deferred capital investments over the last several years, the substitution of capital for labor, de-carbonization, and the "hardening" of supply chains in varying forms. There are a lot of opportunities in these areas. While there is near-term *cyclical risk,* there are *longer-term secular tailwinds* for productivity-enhancing industrials that should endure.

Financials – We currently prefer tollbooth-like financial companies, such as exchanges, payment processing businesses, and some capital market businesses that may benefit from persistent volatility and the end of 0% rate policies. Simpler is better – highly complex banks, and investment platform

businesses are broadly exposed to both the risks of ending a long era of cheap money and opportunity from higher net interest income spreads. There may be some opportunities as the recessionary dynamic gathers steam and leads to asset quality issues. Unlike the 2008 time period, we don't believe what is unfolding will prove to be a *capital event* for most banks, as capital positions are vastly better, as well as loan underwriting standards. It will be difficult to disprove the negative credit and capital risk thesis for at least a few quarters. The regulatory climate for banks continues to limit their potential, and we harbor some concerns about what exactly lies beneath the surface following such a long period of negative real interest rates.

Technology - Tech stocks have, in past recessions, tended to go into and out of contraction rather quickly due to short product cycles. *We suspect something similar* may prevail in 2022-23 and see opportunities in particularly vital semiconductor and software businesses that are non-fungible by their customers. Offsetting this, a large chunk of technology businesses generate their profits globally, making a strong dollar and increasingly poor relationship with China a difficult risk to quantify. Years of low-risk premiums, short operating histories, and associated adulation by investors have led to a somewhat weaker capital discipline mentality by many companies. The large slate of internet-platform businesses has not endured an economic contraction at their present scale, rendering their short operating histories a point of consideration.

RECESSION: WHAT NEEDS RECESSING, WHAT DOES NOT?

Entering a recession, it is important to identify what, exactly, the economy needs less of (i.e., what needs recessing). The ***what needs recessing*** list was covered earlier: the malinvestment bubble in technology platforms, disruptors, and any number of questionable business models and alternative asset concepts. What does not need recessing are some notionally cyclical businesses that never really got going in the COVID economy or the post-COVID economy. This leads to a reasonably constructive outlook for products that have been difficult to produce relative to normalized demand since 2019 – meaning that there is a multi-year supply deficit to produce into. These include autos, homes, and related components of these areas. There is clear and obvious offsetting finance-ability risk. So selectivity is critical.

Commodities – Commodities have tended to be a danger zone in non-inflationary, global recessions, given very high price elasticity to small changes in supply/demand. They are especially dangerous if these conditions accompany a rapidly increasing U.S. dollar versus other currencies. Is this time different owing to the inflation and geopolitics dynamic? There are multiple and conflicting supply/demand drivers to global commodities at this time.

On the positive side, we see a favorable multi-year supply/demand imbalance for food, liquefied natural gas, and some strategic metals, notably copper. It is hard to overstate the impact that the war between Russia and Ukraine has in this regard. While Russia is not an essential source of global demand, it is a very critical supplier of major commodities as well various agricultural products. The loss of any supply from Russia prospectively and weaponization of natural gas supply entails a greater call on supply from North America and other (safer) jurisdictions. It is hard to get great comfort around the investment case for heavier industrial metals, such as iron ore, that feed into Chinese construction demand, given an evident financing and investment bubble.

The biggest of commodities, oil, is likely in a last-hurrah bull market propelled by deficient investment in upstream capacity and non-realism about what rate electric vehicles might displace conventional demand from the world's ~1.5 bn car and truck fleets. Of all the commodity markets, this one seems the hardest to gain comfort in the outlook beyond the next couple of years, but it could be longer than that. Among the reasons for extending the hydrocarbon-energy bull market, we don't see a big shift in realism in the prevailing dialogue about the future of global energy supply and the transition away from carbon. Oil and gas and related infrastructure are needed, as are non-intermittent and non-carbon based energy sources.

This... quickly leads to nuclear energy as the only proven solution that could displace carbon at scale. Unfortunately, the dialogue around nuclear energy is poor and prone to fear-mongering. It takes a lot of time to construct anything, which leads the world back to burning carbon while the bickering persists. We would like to be more optimistic in this space than we presently are given climate change imperatives.

OTHER OBSERVATIONS?

“There seems to be some perverse human characteristic that likes to make easy things difficult.”

– Warren Buffett

There is little question in many observers’ minds, including ours, that the Fed and other Central Banks were too loose for too long, and particularly so throughout 2021, as COVID-driven monetary and fiscal policies outlived their usefulness. Over-tightening and doing so exceptionally quickly, increasing the probability of “breaking things”, does not un-bake the inflationary cake. It makes planning very difficult, damaging the supply-side’s capacity to respond to price changes. The ingredients in this cake were years of malinvestment and underinvestment in key sectors and capacities, an outlandish dose of money supply growth during COVID, and economic scarring from the duration of COVID policies and restrictions.

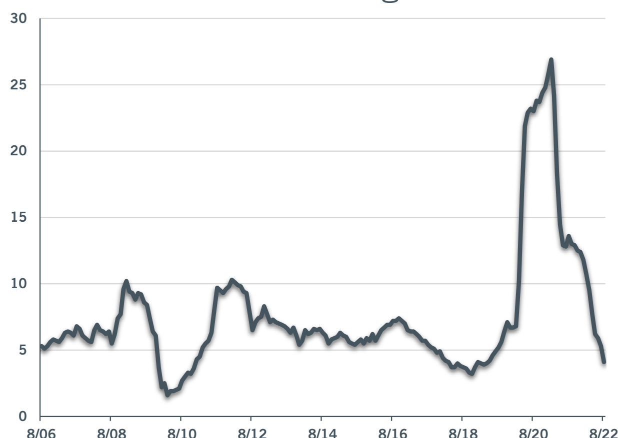
In our view, the prevailing inflation problem would have been/could have been, substantially healed by mid-2023, had the Fed stuck with a pre-June 2022 plan to reach an above neutral rate in the 3%+ range coupled with the constrictive effect of balance sheet shrinkage. This would have entailed very low money supply growth, which is wholly incompatible with current inflation levels, rising mortgage and auto loan rates, as well as a higher dollar. This more patient and straightforward narrative is not to be.

To this point, our in-house view has been to focus on money supply growth and trends as the best predictors of inflationary pressure and financial market conditions. Under the auspices of COVID-relief and various programs, the Fed took money supply growth up to levels 2-3x their post-GFC peaks. In 2009, a legitimate monetary shock necessitated a larger money stock to absorb the blow. By late 2020, it was clear that banks were not enduring capital losses owing to Covid and that the financial system was working smoothly – meaning that the gigantic money supply increases reached the broader economy.

The COVID money supply growth extravaganza is all reversing out now, with the most recent (August) reading at 4.1% - a level wholly incompatible with 8% inflation and positive real GDP growth. However the Fed seems poised to go further, leading to some really wild stuff!

M2 MONEY SUPPLY

YoY% Change

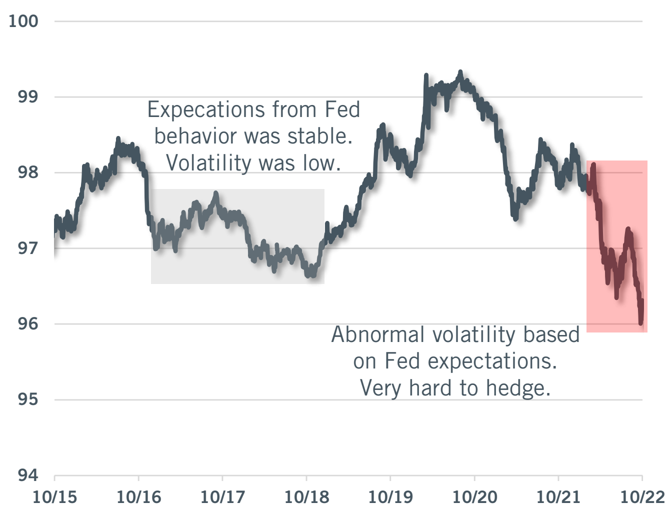


Source: Bloomberg

The impact of an unpredictable Fed and aggressive rate increases can be seen in financial conditions and currency movements. Forward currency swaps normally incorporate expectations of future interest rates (100 less the value of the forward swap is the expected interest rate). You can see that during the 2017-18 period of modest and predictable rate increases, forward rates barely moved; there were no gap-downs. (There was one when Trump was elected, not the Fed’s doing). In 2022, there are several gaps, as the Fed’s behavior, the terminal rate, etc., have become highly unpredictable.

EURODOLLAR SWAP RATE

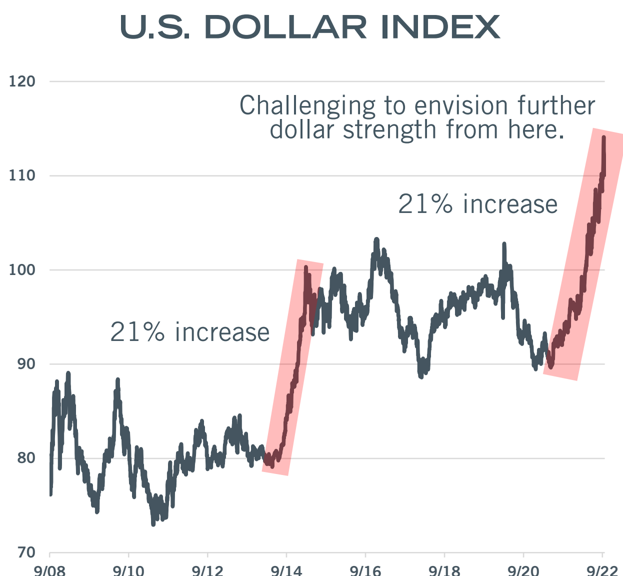
DECEMBER 2023



Source: Bloomberg

One of the big structural reasons why Emerging Market nations are less developed is that high macro variable policy volatility makes longer planning horizons impossible. This chronic instability exacts an extremely high long-term economic and social cost. Growth, development, and CAPEX projects need to happen quickly. This leads to poor capital allocation decisions and dampens wealth, leading to more short-termism and volatile social realities. It's always proven to be a difficult cycle to break. Hence it is disturbing to see aggressive policy flip-flops that are accomplishing a similar outcome of extreme volatility that impair confidence in how one can predict, and plan for, the future. This kind of volatility in shorter-duration fixed income markets impacts the provisioning of liquidity and price discovery, which becomes rather haphazard.

On a more positive note, the scope of volatility in Eurodollar swaps, and in the movement of the U.S. dollar in general, have reached extremes of volatility and pace. A less hawkish/more predictable Fed probably brings these volatility sources down from current levels.



Source: Bloomberg

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