Knightsbridge
WEALTH MANAGEMENT

October 16th, 2024

Fall Quarterly Commentary

"What really frightens and dismays us is not external events themselves, but the way in which we think about them. It is not things that disturb us, but our interpretation of their significance."

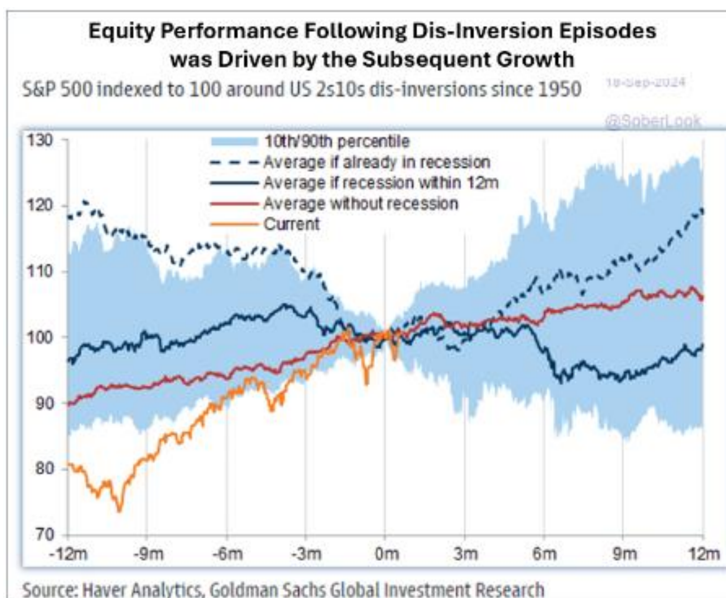
Epictetus (circa AD 50 – 135)
Slave and Stoic Philosopher

Despite brief intra-month pullbacks in both July and September, the S&P 500 Index has delivered six straight positive months while surging to all-time highs. In other good news, the all-important 10-Year Treasury yield has fallen back to where it began this year (around 4%), as inflation continues to head toward the Federal Reserve's 2% target (the one-year trailing rate is 2.5%, down from a peak 7%+ level).

It is important to note that lower inflation does not mean that prices are coming *down*, which is unlikely to happen. Rather it means that prices are no longer rising at such an alarming rate. Inflation has been a problem, with prices in general up 23% over the past five years. Food and housing were up even more over the same period, at 27%. Inflation was a global phenomenon, likely caused by supply disruptions coupled with stimulative policies that put money into the hands of those likely to spend it. Fortunately, the worst of the price increases appears to now be behind us.

With prices no longer rising quickly, the Fed has taken its cue to cut short-term interest rates. Having completed its inflation-fighting mission, the Fed no longer wants interest rates restricting economic activity. The recent half percent rate reduction helped "un-invert" the Treasury yield curve back to its natural state, with 10-year rates higher than 2-year rates.

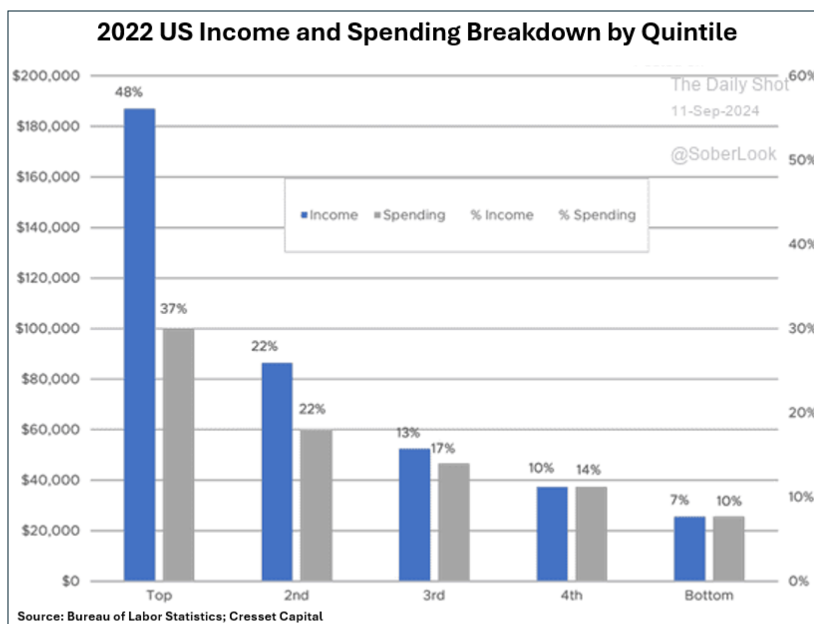
Historically, the yield curve uninverting has been an economic warning sign. This time may be different. Normally, the Fed starts cutting rates when it sees economic weakness. Today, the Fed is cutting rates because it is finished taming inflation. If the economy avoids recession (as so far seems likely), history indicates that forward stock market returns can be solid.



The biggest risk the past few years has been runaway inflation, and that seems off the table...for now. This has fueled the stock market's recent exuberance. However, continual federal government spending deficits mean that avoiding an inflationary spiral is never a certainty. Remember, inflation is caused by an excess of spending beyond the capacity to produce. When a government spends more than it taxes away from its citizens, the result is a net increase in spending, which adds to inflationary pressure.

The inflationary force of government deficits has been present in our economy for a long time. Yet inflation was remarkably restrained until the past few years. Perhaps our natural economic state is *deflation*, which has only been prevented by recurrent government deficits!? What might have "delinked" inflation from deficit spending? Possibly it was the integration of China's cheap productive capacity into the world economy. Or perhaps there is another dynamic which results in less spending that offsets the government's increased spending.

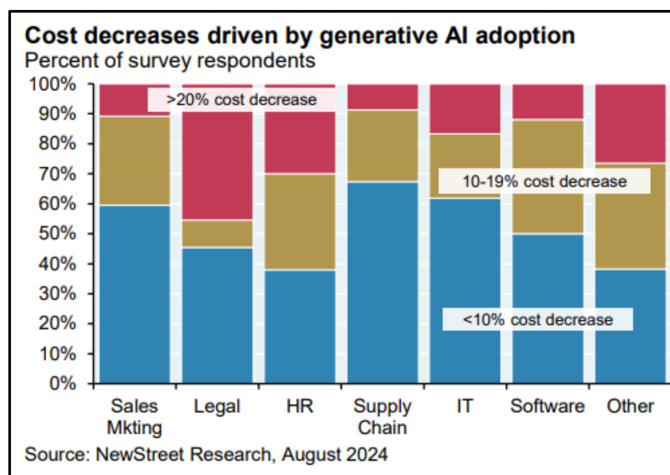
The affluent, with their basic needs met, are more likely to invest their extra money as opposed to spending it. As economic production is increasingly driven by "things" rather than "people", and due to the "winner-take-all" nature of software, more money flows to the affluent who own the software and other productive assets driving the economy. The less affluent, who spend most of their paycheck, reduce their spending when they take home less of the economic pie. The propensity of the winners in this economy to save decreases inflation[1], creating room for more government spending. Thus, perhaps increasing income inequality is one of the main forces keeping a lid on inflation.



[1] The extra savings decreases inflation for goods and services but increases inflation on assets as savings are invested.

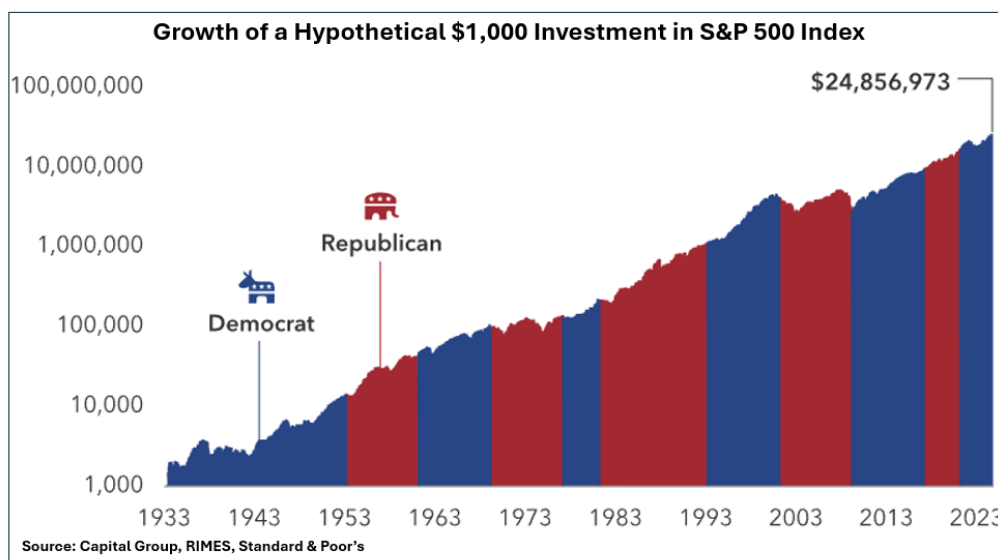
This theory (and of course, it is only a theory) would explain how the government has been able to issue more and more debt (i.e. Treasuries) without pushing interest rates higher. The affluent have a lot of savings to buy these bonds. Government deficits can be sustained for so long as excess savings are willing to finance them.

There are still more possibilities as to why inflation has moderated in the face of increasing government deficits, such as artificial intelligence (AI) enabling us to get more done with less[2]. Whatever the reason, inflation is softening and we can breathe a sigh of relief.



Source: NewStreet Research, August 2024

We will only briefly touch on politics – we're as exhausted as everyone else. Both presidential candidates have tossed up questionable economic policy ideas. Still, our baseline position is usually that politics don't much matter for the overall direction of the stock market.



Source: Capital Group, RIMES, Standard & Poor's

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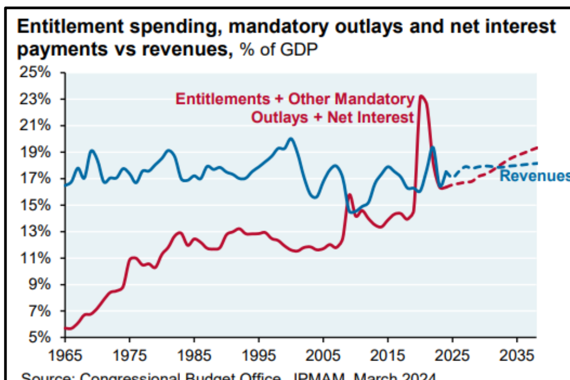
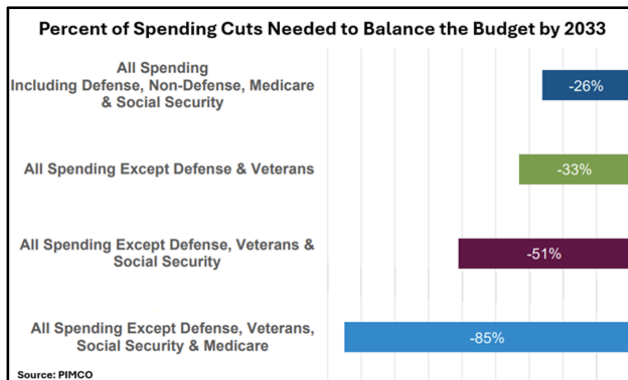
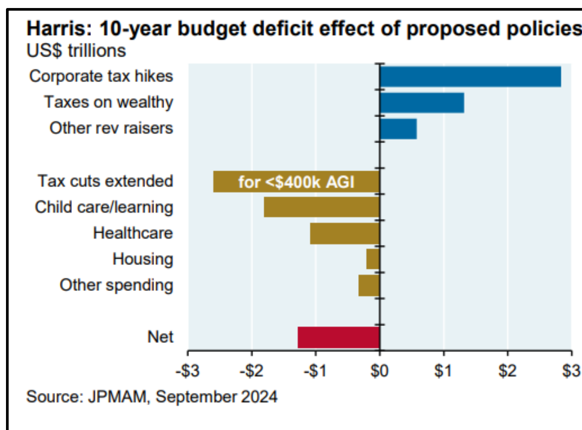
[2] We get lots of questions on how we are investing to take advantage of AI. While we did recently buy a semiconductor stock, the better answer is probably that we benefit from AI by investing in nearly ANY company. AI will enable companies to lower their costs, which translates to higher corporate profits.

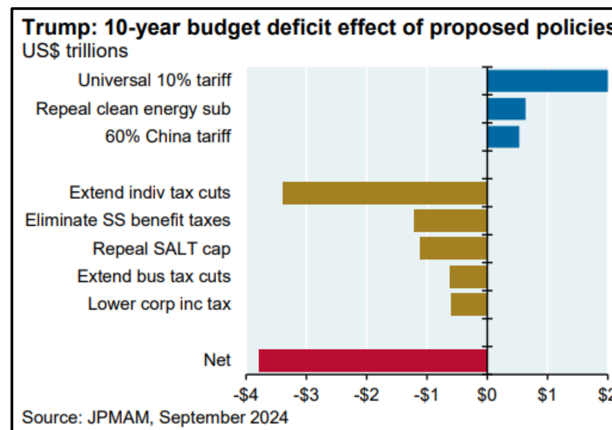
This time politics might matter because of the government deficits we mentioned earlier. Our deficit problem isn't driven by the spending that Congress authorizes each year, but rather by the continually rising spending that happens "automatically" (mostly entitlements[3]). The chart on the left below shows that entitlements and other "mandatory" outlays (including interest expense) will exceed federal revenues within a decade. The second chart below shows that balancing the budget while avoiding any reduction in Social Security and Medicare benefits, defense spending or veteran benefits, requires the government to spend 85% less on everything else by 2033.





Both candidates for president have proposed policies likely to increase government deficits[4]. The ultimate solution to our spending problem must involve entitlement reform, which isn't coming until forced by a crisis. The deficit may indeed affect markets following this electoral season, if Democrats win and try to delay a fiscal reckoning by raising taxes. The Harris campaign's proposed increase in the corporate tax rate from 21% to 28% would directly hit corporate profits and stock prices.

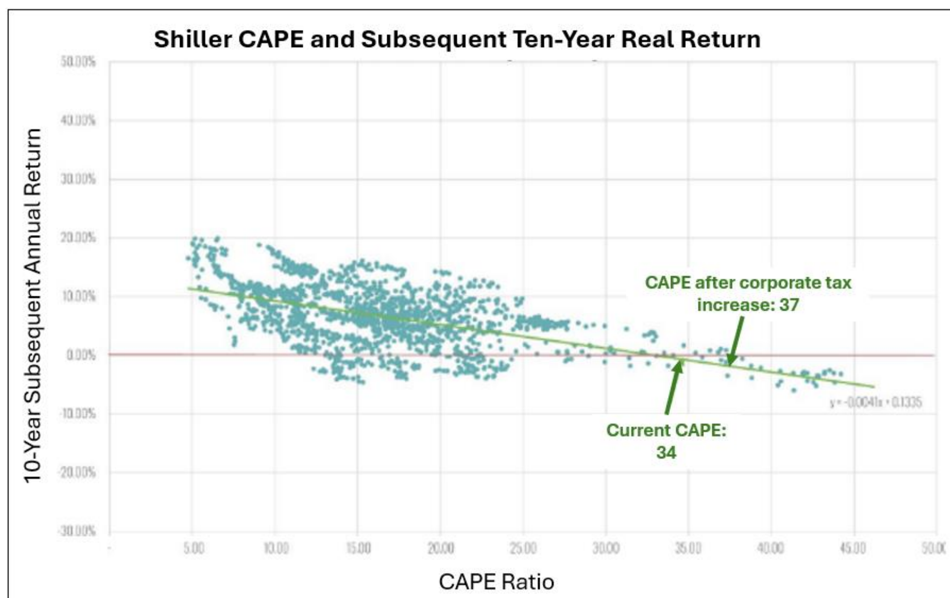




[3] We try to be impartial, but this problem can be laid squarely at the feet of Democrats, who mercilessly attack Republicans any time they start poking around entitlement reform. Unsurprisingly, Republicans have stopped talking about it as a solution.

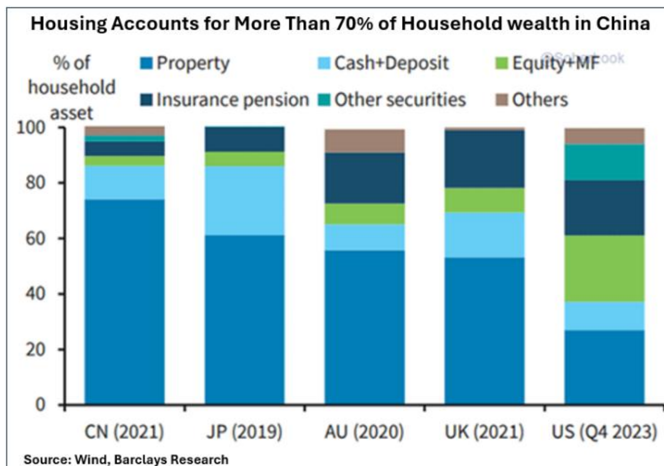
[4] Based on estimates by JP Morgan Asset Management and others.

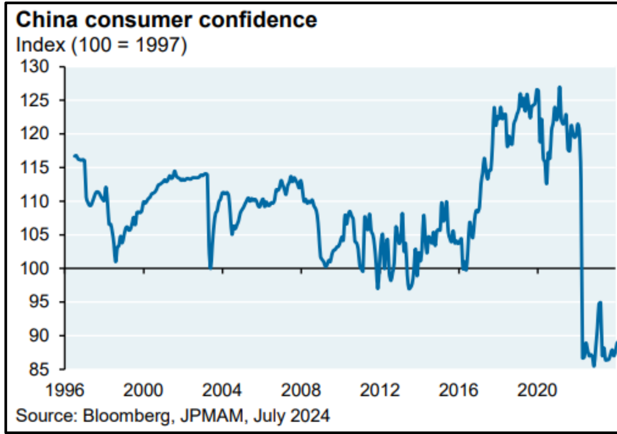
The market seems to be ignoring this risk given today's above-average valuations. Below we display a chart we have emphasized before, which compares 10-year forward returns to the Cyclically Adjusted Price to Earnings (CAPE) ratio (a measure comparing today's S&P 500 Index value relative to the past 10 years of inflation-adjusted-earnings).



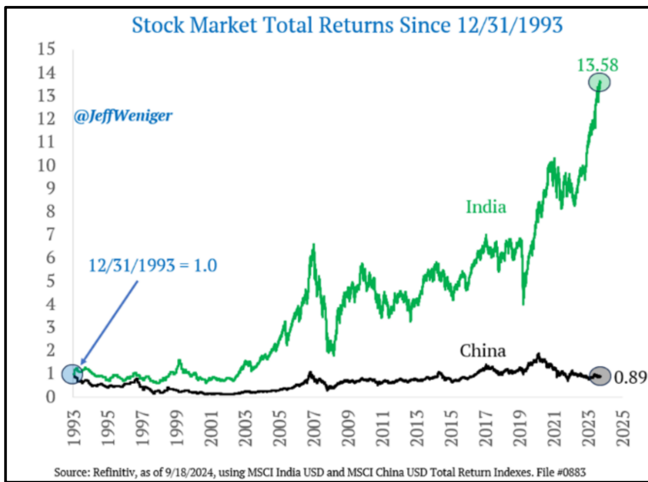
As you can see, the current CAPE valuation reading is extraordinarily high, which indicates lackluster U.S. equity returns over the next five and ten years. Further, those past earnings will be overstated if corporate taxes head higher. By simple math, an increase in corporate taxes from 21% to 28% renders corporate earnings 9% lower. This would increase the above CAPE ratio from 34 to 37, dropping longer-term expected returns for the stock market into negative territory.

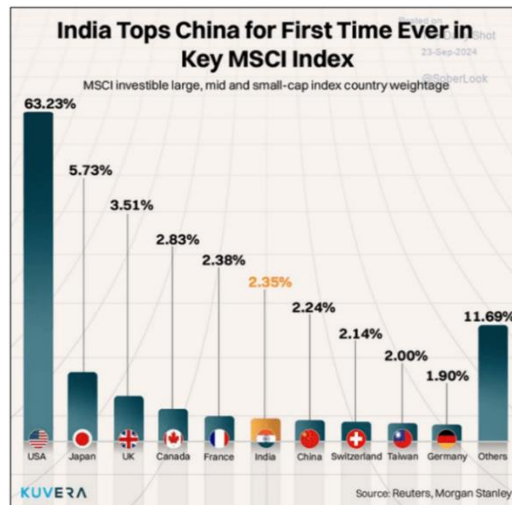
In the U.S., the economy is strong and markets are ebullient. Things couldn't be more different in China, where a real estate bubble has clearly burst. For years, local Chinese officials hit their economic growth targets by encouraging developers to build and build. All construction counts toward GDP, whether needed or not. For a while, the Chinese public fueled rising prices by investing in these housing units. However, no matter the cost to build, ultimately an apartment that no one wants to live in doesn't have much value. Housing accounts for an outsized portion of household wealth in China. Thus, declining property values, now in their third year, are a gut punch to the Chinese consumer and economy.

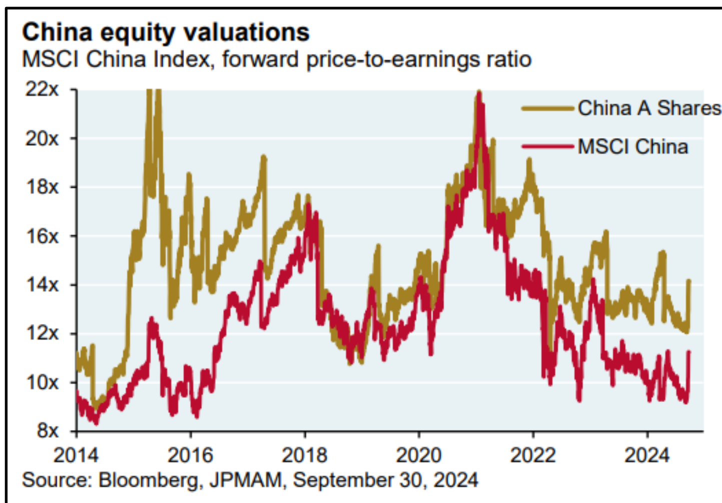


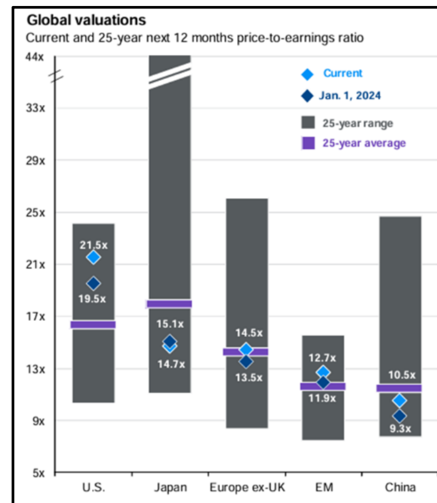


A weak economy, trade tariffs, and Xi Jinping's turn away from capitalism have left China's stock market bruised and battered. China's market stands below its 1993 level while other emerging markets like India have soared past it. Despite the economic mess, or perhaps because of it, we have our eyes on the Chinese market as it has become quite inexpensive.









It will take China years to clean up its property mess and turn the economy around, but some big things are happening which might spur its stock market upward. First, the U.S. is cutting rates, which provides room for China to loosen its monetary policy in lockstep. But the real news came one week ago when Chinese officials unleashed a barrage of stimulus measures enumerated below. Most striking is the lending to companies for them to buy back their own stock, a stark contrast to the Chinese market's long history of not returning capital to shareholders. We have heeded these important signals and recently added a Chinese exchange traded fund (ETF) to our active equity strategy.

Primary Target	Lever	Details
Economy	Monetary	50bp cut to the reserve ratio requirement
		20bp cut to the short-term policy rate (PBoC 7d repo)
		30bp cut to the mid-term policy rate (MLF)
	Fiscal	One-off cash transfer to people living in poverty
	Macro	~50bp cut to the interest rate on exisitng mortgages
		Expand loan guarantees for a program that subsidizes state-owned enterprises to buy vacant homes for conversion to social housing
		Lower down payment requirement on 2nd home purchases to 15% (previously 25%)
		Expand the availability of loan extensions to more business
Markets	Monetary	Set up securities, funds and insurance company swap facility to allow more funding for equity purchases
		Set up relending program for stock repurchases and holding increases
	Market Regulation	Advocate and refine the regulation for more mid- to long-term capital to invest in the stock market
		Encourage mergers, acquisitions and restructuring
		Request listed companies to perform market value management (e.g. encourage buybacks)

Source: Bridgewater, JPMAM, 2024

We will continue to seek value across markets, particularly given relatively high U.S. valuations these days, so long as we feel we are prudently managing your risk as part of that quest. As always, we endeavor to carefully further your finances any way we can.

We leave you with our firm's three core values: 1) pursue excellence in everything we do, 2) always do what's right for the client, and 3) treat each other well.

Sincerely,

John G. Prichard

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

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