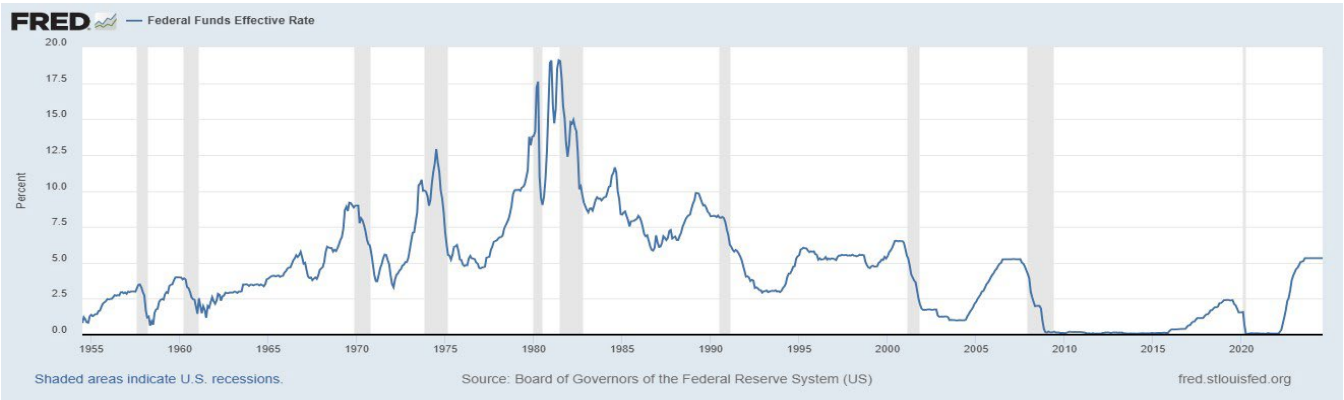
Investment Strategy
October 2024

The S&P 500 suffered two very modest corrections in the third quarter before continuing its mechanical climb to new all-time highs. The tech-heavy Nasdaq 100 has failed to retake its highs, potentially indicating failing leadership. The big news was the Federal Reserve cut short-term interest rates by 0.50% to 4.75%. This was the first rate cut since the Fed rapidly increased interest rates in 2022 to tame a surge of inflation. While the reduction happened in late September, the market began pricing in a series of aggressive rate cuts starting in May. Over the past 6 months, the 10-year treasury fell from roughly 4.7% to 4.0% today, benefiting mortgage rates and other long-term borrowing. This has relieved pressure on many overindebted companies, real estate deals, and numerous other types of financial investments. The Fed made this decision to encourage credit to enter several stressed areas of the economy and prevent unnecessary economic damage being caused by the high interest rates. As we have discussed previously, mortgage demand has been anemic and big city commercial property market is in disarray. More quietly, there has also been severe stress in private equity linked companies which now employ a sizable segment of the U.S. workforce.

The Fed typically starts reducing interest rates when important economic sectors or industries become financially stressed. As a result, interest rate cuts have often foreshadowed a recession over the past 70 years. It's generally believed this occurs because central banks tighten financial conditions too much and then pivot to easier conditions too late to prevent a downturn. More accurately, higher interest rates break unstable financial structures which leads to a pullback in economic activity. We believe this time will be no different as bad investments have been built up across the economy over the past 15 years of ultra-cheap borrowing and profligate government spending by China and the U.S.

Adjusting short-term interest rates is the primary tool used by the Fed to achieve their dual mandate of stable prices and full employment. If inflation is running hot, the Fed will increase interest rates to cool the economy. For example, boosting rates on credit cards will marginally decrease consumer spending, easing the strain on the supply of goods. The practice of using the "overnight" interest rate to control the cyclical moves in supply, demand, and inflation is the bedrock of modern economics. While its effects are generally well understood and accepted, they operate with long lags and can be difficult to calibrate well. As one can see in the chart below, by the time rates start falling (blue line), recession is usually close behind[1](grey shading).



[1] Or already started.

Over the past 15 years, the Fed went beyond this well understood tool as they tried to offset the magnitude of the 2008/09 financial crisis. To keep it simple, they engaged in new and experimental policies to influence long-term interest rates, benefiting mortgages and other long-term borrowing. While 5 to 10-year interest rates are influenced by the Fed's "official" short-term rate, the Fed engaged in additional financial gymnastics to artificially suppress longer rates. The Fed found this necessary because they had already moved short-term rates to 0% and they believed these policies were the equivalent of another 0.50%-1% rate cut[2]. Unfortunately, an underappreciated side effect to these policies was to induce asset price inflation (stocks, bonds, real estate) and investor risk taking.

Higher interest rates have been shaking the foundations of overpriced assets and marginal businesses for the past 2+ years. This is causing unrealized investment losses to pile up in several previously hot sectors. However, most of the losses remain obscured by bubble-level valuations in the stock and housing market and the enormous growth in "unmarked" private equity-type investments. In addition, many of the losses sit on the balance sheets of banks, insurance companies, and large endowments who don't publicize their investing missteps willingly. For example, the fastest deflating asset has been big city commercial real estate.

While it is not our expertise, commercial real estate prices were considered red hot as far back as 2015. In fact, then Fed Chair Janet Yellen mentioned they were monitoring the sector due to rich valuations. These high prices continued upward for another 5+ years before colliding with drastic changes in human behavior following COVID which reduced downtown traffic by 40% or more in most large cities. Let's assume a big tower was sold for $100 million in 2018. Normally these deals would include roughly $30 million of equity from investors along with $70 million of debt from various lenders. Recent distressed sales of these types of buildings across the U.S. have realized prices down 70%+ compared to pre-COVID[3]. This means the equity investors have suffered total losses in many commercial real estate deals made over the past decade, leading to "keys" being mailed back to lenders. Meanwhile, the lenders are likely to lose a sizable portion of their investment as well. Needless to say, there won't be many new office buildings built any time soon.

While the commercial property market is the most obvious casualty, there are a countless number of other financial structures across the world straining at current interest rates. The "elephant in the room" is the U.S. private equity industry[4]. This industry takes assets private (companies, real estate, debt, etc) and uses aggressive financial wizardry to boost returns. Everyone knows there are enormous losses in private equity linked investments as they scramble for expensive new financing and their companies regularly go bankrupt. Conveniently, the industry gets to estimate the value of their own investments and they have aggressively used this privilege to keep reported values high. Meanwhile, many of their investors are incentivized to go along with the charade (banks, insurance companies, and endowment money handlers). The concern is the industry has grown enormously over the past 20 years. It's estimated private equity linked firms employ 8 million people (6-7% of the U.S. workforce), including a painfully large

[2] Europe went the other route and simply made interest rates negative
[3] Doesn't include any major upgrades also made to building under ownership
[4] And the epic real estate bubble in China and generational housing bubbles in Australia, Canada and many other foreign "Tier 1" cities.

portion of our healthcare industry. **There are currently $3.2 trillion[5] of these investments that are now trying to "exit" by selling the indebted company back to public markets or another company**. While it is impossible to know what is truly going on, we can confidently assume that a large chunk of this $3.2 trillion has now been impaired. We believe the Fed is reacting to these known problems with their unusually aggressive 0.50% cut[6].

Jerome Powell is a unique Federal Reserve Chairman because he did not come from a leading economics department. His background is in the private equity industry, giving him a better understanding of what is going on in these businesses and their underlying investment values. We believe he knows the Fed has strangled credit enough to clear out the bad actors and mark down a good portion of the poor investments from the past 15 years of ultra-low interest rates. The problem is this was the most financially stimulated economic expansion in human history. Looking back at the chart showing 70 years of interest rates, you will note the last 15 years have had no parallel. Never have central banks moved rates to essentially 0% for years while also buying massive quantities of government bonds to suppress longer term interest rates. We have also seen the two largest economies, China and the U.S., run massive government deficits to keep the party going. The combination of ultra-cheap borrowing coupled with a very long economic cycle has allowed bad businesses and investments to proliferate and grow large. As a result, there are unknowable levels of weak financial structures that have built up over this period.

With the "fuse being lit" the Fed can now back off and allow nature to run its course. The knowledgeable players have already moved to the exits as corporate executives unload massive amounts of their insider stock[7] and even Warren Buffett has decided to rapidly expand his cash pile from $190 billion to start the year to $278 billion today. This is one of the highest percentages of cash Berkshire Hathaway has ever held in the 94-year old's legendary career. The only area Buffett has been buying heavily over the past year has been the oil company Occidental, an unusual position in his extensive track record[8]. As it stands, there are a tremendous number of overpriced and dangerous investments available today (looking for buyers!) while only a few areas offer attractive value. There is also likely to be an opportunistic buying period on the way as overleveraged investors (or their lenders) are forced to unload assets at fire sale prices, much like in the commercial property market. To take advantage of this it is critical to maintain a stockpile of available cash (treasuries) for rapid investment. As we continue to stress, extreme caution and conservative portfolios are appropriate in the current environment until better investing opportunities present themselves.

Sincerely,

Keating Investment Counselors, Inc

[5] Bain & Company *Private Equity Outlook 2024*
[6] 50 bp interest rate cuts have historically been reserved for crisis periods
[7] Only 15.7% of corporate insiders have been net buyers of their stock this year, the lowest in the past 10 years.
[8] Buffett doesn't invest in energy very often

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