LONG BRIDGE
CAPITAL MANAGEMENT, LLC

Johnny One Note and the 493

The Market's Johnny OneNote Problem

Those of us who spend any serious amount of time involved with the investment world have almost certainly become familiar with the financial community's penchant for slick clichés and acronyms. So, for many, it won't come as a surprise when I say, that is still (and sadly will forever be) the case.

Unfortunately, while this penchant for catchy lines is with us all the time, there are occasions when the financial crowd is at a loss in coming up with creative new catchphrases. We are currently in one of those stale periods. So much so, that they have taken to tweaking old acronyms out of desperation for lack of a better alternative. The best they can do is give us the "Magnificent Seven" and the 493 (500 minus 7; get it?). It is almost disheartening to watch the investor crowd struggle to come up with a fresh spin on things with so little success. We are currently suffering through one of those periods, which makes it time for us to give our best effort to offer a fresh look.

Let's start with a quick discussion of the market's core problem. It's that the stock market has had no success in identifying a sector of the market or the economy with sufficient conviction that it can lead stocks to higher prices. So, the markets have gone back-and-forth with all the categories of momentum investors chasing a small number of the same stocks, fashionably named the "Magnificent Seven." Up and down, we go without the ability to move fundamentally higher. Clinging to seven super favorites out of 500 is what defines our Johnny OneNote problem.

This is partly because today's markets are so dramatically different from those of 30 or 40 years ago. Back in the "old" days, the American equity markets were predominantly a vehicle for allocating capital around the country by rewarding the more successful companies with higher public valuations—and easier access to more capital. This also forced the failing ones to redo their business plans in order to get new capital. Individuals and investment advisors could trade those individual company stocks on a short-term basis, but trading wasn't the primary

reason for the stock markets existence, and most decision-making, whether it was well thought out or not, was based on the presumptive result of fundamental analysis of each company's potential. Today things couldn't be more different.

Today, the capital raising function in the U.S. has many more channels than back then, and as a result, the day-to-day trading in stocks has become an entirely different undertaking. Now, we have hundreds of thousands of investors of all sizes who do little or no fundamental analysis and who buy and sell stocks largely based on an entirely different set of parameters. Their goal is solely to trade their way to a profit by buying and selling stocks daily or even quicker. This is the world of trend following traders.

Today, several distinctly separate groups have roles. In terms of trading volume, the largest group of role players are the computerized trading systems built upon extremely high-speed computers that analyze the stream of transaction data from the exchanges in an attempt to sense when to jump on trading patterns to generate very short term (down to nanoseconds) profits. They don't care at all about the fundamental performance of the companies that have issued these stocks.

A second group are the technicians and algorithmic traders who use assorted statistical techniques to interpret where all of the traders or investors are going with their money and to opportunistically capitalize by jumping ahead of these perceived trends. Once again, this type of analysis does not depend on understanding a company's operations, but rather whether a crowd of investors is growing more or less interested in the stock of each company at that specific moment in time.

Finally, there is yet another group of newbie investors (the ones we call Robinhoodlings) who have emerged in the last several years, generally with limited amounts of money, but who operate with the belief that their network of communications with others of similar mind would produce success. They want to believe that this network will compensate for only superficial understanding of the companies they invest in. We doubt it.

These various groups and the collective effect of their different behaviors, represent over 3/4 of the daily trading in the markets. JP Morgan in a 2017 study

came to the conclusion that only 10% of trading was any longer tied to some kind of fundamental decision making. Everything else is part of the trading game.

The conclusions of that study are even more true today. America's stock markets have become a trading game for different types of players. As a result, only rarely do stocks move based on the collective opinions of a number of fundamental investors.

One thing that investors can always be sure of is that the equity markets will ultimately always go where the fundamentals justify. Period. It may occasionally be a painful process to get there, but it always ultimately proves to be true. And, given that reality, here's what is important right now:

- The economy has clearly been slowing, but a number of factors are combining to mitigate the rate of decline.
- As a result, inflation is likely to continue to decelerate, more or less in line with Federal Reserve hopes.
- Unfortunately, because of a number of fundamental global economic realities that are too large to address here, we remain skeptical that the Federal Reserve can get inflation down to its sustainably low 2% level. Our assumption has been and still is that 2-3% is a more realistic expectation.
- For the time being, though, continued progress in the direction of its 2% inflation rate will allow the Fed to become gradually more accommodative and to start lowering short-term rates in 2024 and perhaps after one or two more upticks.
- Longer-term, we expect all of this to add up to gradually lower short-term rates, but likely very little (we expect virtually none) decline in long term rates—perhaps even a modest rise.

The Economy's Johnny OneNote Problem

Nothing about the above forecast, if it occurs as predicted, is likely to be all that surprising to the investment community. The gradual economic slowdown that underpins our predictions is also close to what we would characterize as the current consensus among investors. Unfortunately, however, this widely expected scenario has, within it, the seeds of a dramatically different outcome than what investors are generally expecting. If we're reading the signs coming from the

financial press correctly, way too many of the financial community will be disappointed by what follows. This is what we're calling the Johnny OneNote problem. Far too many public forecasters are singing the same note— predicting that economic growth will reaccelerate after a modest or almost nonexistent recession. We are among those who do expect at least a modest recession, but the problem we foresee is that far too many forecasters are predicting the reacceleration of economic growth after the recession. *We're not buying it—no reacceleration.*

Like Johnny OneNote, all these investors have but one note they sing—recovery, recovery, recovery. It didn't get Johnny OneNote and his single spectacular note very far, and it's unlikely to get them very far either. They are denying several challenges that we think the economy and therefore the market is going to have to face in the near future. All of them negative and all of them likely to disappoint investors.

Several of these challenges are the "fruits" of one hugely important uh phenomenon. They represent the late-stage evolutions of economic behavior, driven by 40 years of declining interest rates—a period during which the 10-year Treasury declined from a yield of 16% to 1%. All sorts of irresponsible behaviors have been allowed to flourish in this era of declining and ultimately near zero interest rates. Fixing these mistakes is going to take years.

Among other things, it allowed the federal deficit to grow massively with only limited consequences. This was possible because the cost to carry the increasing amount of debt on the federal budget was offset by the steady decline in interest rates. During this period total federal debt as a percent of GDP grew from only about 30% in 1980 to over 100% today—and today its growing by an additional 6-7% of GDP ***annually. That's about $1.7 trillion.***

- How long this can continue is unclear. During this period, the U.S. has become one of the most irresponsibly stimulated economies in the world. So, when it comes to even more irresponsible spending, the game needs to be over. The question is who's going to break the addiction?
- Considering the pathetic two-party dysfunction in Washington D.C., along with the growing public awareness that our federal debt is now large enough to be a serious problem, there is very little chance that our federal

government has the will to step in and stimulate the economy this next time.
- The American consumer and corporations have also expanded their total debt. In the case of consumers this increased amount of debt has occurred in conjunction with significant appreciation in home values. As a result, homeowners are not in particularly bad shape. But they're also no longer able to refinance their mortgage debt at still lower interest rates in order to get lower monthly payments. If one combines the end of the refinancing game with comparatively high charge account balances, and the gradual erosion of pandemic payment balances, the consumer has no ''financial bullets" left to lead the charge, either. The consumer drives about 70% of the economy.
- Finally, corporations have their own set of issues. Many of the companies that came public in recent years via highly priced IPOs, started their life with a bucket load of cash, and way too many seemed to expect that more cash would be available whenever they needed it. They're now facing the ugly truth that this will not the case. Silicon Valley Bank was a proxy for, frankly, really stupid banking practices that ignored all of the core banking principles in order to grow faster. The behavior of some other banks wasn't as extreme, but they resorted to some of the same irresponsible behavior. They're all now obliged to pull in their horns because of more aggressive regulatory oversight in combination with higher interest rates on deposits. The effect of this behavior unfortunately spreads the problem to borrowers who built their businesses or real estate ownership on the assumption of everlasting low interest rates. All of this now has to be unwound, hopefully in a reasonably, orderly way as interest rates move to more historically normal levels. So, consumers and corporations **also** will be unable to step up aggressively and restart the economy.

As a result, domestically, no one is going to show up to re-stimulate the U.S. economy. There are some who hope that help will come from foreign sources, but China's problems are increasingly problematic (seriously structural), and growth rate expectations continue to be ratcheted lower. Europe has its hands full unfortunately with the mad Russian. Finally, there are some emerging economies like India and Brazil that are showing promising growth potential, but they're not big enough to carry the global economy.

So, what is an investor to do?

With apologies to our somewhat corny reference to Johnny OneNote, we would argue that equity investors really must focus on one thing. That is the underlying fundamentals of the companies that they choose to own. Because, thanks to our momentum-driven market, there are plenty of legitimate investment candidates—companies that are progressively better run and very modestly priced—that are "investor orphans."

These bargains have been created because they are not the center of attention. The value in their stocks is especially compelling in an economy where the quality of broad future growth may be open to question.

Putting it All together

When it comes down to putting all of our thoughts together, here are our favored priorities. They start with wanting to make sure that each client has an asset allocation that best fits their circumstances. So, even though we favor stocks over bonds at the present time, it's important to acknowledge that bond yields are near the highest levels that they've been in almost 15 years. So, if limiting risk and achieving a predictable return are priorities, this is an OK time to be putting money to work in the bond market.

On the other hand, if a smooth, predictable return is less important, we believe there is still excellent value in the kinds of stocks that have been neglected. One of the side benefits of an assortment of these unloved stocks is that their dividends are dependable, and quite often high enough to provide almost half of what the bond market will offer through the dividends alone. This is even true when their total appreciation potential is much higher.

Stay tuned.