LONG BRIDGE
CAPITAL MANAGEMENT, LLC

Trampled by the Sacred Cows

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For almost a year now, those of you with whom we have regularly spoken or who have read our commentaries have known that we felt the long bull market was coming to an end and that the upside momentum would ultimately break down completely, giving way to a meaningful selloff. After the last few months of decline, there is no longer any doubt that the time of transition has arrived. The surprise though will be when we point out that, although the dramatic sell off the last couple of months has everyone's attention, the bear market has been unfolding for much longer than most believe. The bear, for some portions of the equity markets, actually begin with the breakdown from the frenzied peaks in the IPO and SPAC markets in February 2021—***15 months ago.*** Since then, the bear market has played out in fairly predictable ways, with the breakdown of the very speculative stocks giving way to the decline of the less speculative stocks, then ultimately the decline of the better-quality ones and finally the "sacred cows" like Microsoft and Google.

To understand this bear, one has to start out with an understanding of the crowd psychology that explains this bull market of the last dozen or so years. All bear markets, and for that matter, all bull markets have some common attributes. But it's not the common aspects of these markets that's important. Rather, it's understanding what differentiates each of them from the others that is so important.

The bull market that evolved for the last dozen or so years has had a distinctly different behavioral underpinning than its predecessors. It is the first that has included such massive participation by media, both live commercial media (like CNBC and Bloomberg TV) and social media like Twitter and Reddit. Somewhat as a result, for the first time it drew in millions of amateur investors that, all too often, invested using youthful arrogance and chat room opinions as a substitute for investment knowledge, effort, and experience. As long as they were able to keep convincing each other how to invest, it was "game on." But reality has a way of creeping in on delusions and in the last year or so, it has begun to ruin the masterfully constructed mass delusion of the newbie amateur investors and their social networks with some of their

favorite stocks declining by 70 or 80%. But, as we mentioned above, because of the different factions of investors, the decline didn't break down all of the equity market segments and their respective devoted participants at the same time.

One of the strange aspects of this market's selloff is that the breakdown of the equity markets has not occurred in a manner customarily more coincident with the much later deterioration in the economy. This very real and mature bear market decline has simply not been matched with a similar dramatic decline in the economy—*yet*. We're not entirely sure why the stock market's negativity has gotten so far ahead of the economy, but our suspicion is that the media-driven nature of this market and its preoccupation with very short-term trading is in part the cause. This market cycle began by first accentuating the manic bullishness, which in turn, induced the absurdly high valuation levels. This in turn subsequently accelerated the stock declines because of the immediate unrelenting flood of news through the media sources. The fact that many stock prices were so foolishly in excess of their justifiable levels based on their fundamentals, also contributed to the sharpness of declines once the bull market's euphoric mentality was broken.

So where does that leave us after the several almost 1000 point daily declines in the Dow Industrials in the last few weeks? We need to start by grounding ourselves in the current economic reality. One need only watch the evening news to get a sense of the economy's challenges. Inflation is significantly higher, interest rates are rising, and consumers are taking on large amounts of installment debt in spite of surveys showing that consumer confidence is collapsing. Yet in spite of all this negativity, the economic statistics have remained surprisingly strong. Interesting dichotomy—an imploding stock market at the same time that unemployment is very low and economic growth has still been reported as positive. That leaves us with the question of what the divergence means and how investors should address it. A brief review of several the individual economic aspects will help.

THE FACTORS

<u>Inflation</u>

The very high inflation report for the months of May and June reinforces the argument of those who believe the U.S. is entering a period of persistent inflation. Clearly the high inflation is here. Not so clear, is how long it will last and ultimately what it will take to slow it down. At present there are hundreds of economic and investment experts who are trying to predict the answer to that question, all with no conviction.

The problem is that the U.S. has never experienced a truly comparable situation. The very high inflation of the late 70's actually developed toward the end of a fifteen-year period when the U.S. economy dominated the whole world's economy to an extraordinary degree, allowing inflation to accelerate because there were no consequences with limited serious global competition. The U.S. was so economically dominant because so much of the rest of the world was either rebuilding after World War II or still primitively undeveloped. Today, that is not the case. The U.S. faces significant competition in most industries.

Today, however, because the U.S. no longer dominates like it once did, this time the cause of inflation has to be different. Unfortunately, it appears to be the result of a number of different circumstances all occurring at the same time and in most cases due to causes which are outside the U.S. There is war in the Ukraine, Covid virus shutdowns in China that led to factories being shut down in China, super high oil prices and commodity shortages due to the war and drought. Obviously, none of these problems are under the control of the U.S. Federal Reserve. Unfortunately, therefore, the Fed can't cure them either. Nobody easily can.

> ***Expectation:***
> ***The causes of inflation are global and too diverse to be easily treated. Inflation will moderate as the year progresses, but not to a level as low as everyone would like.***

Interest rates

The level of interest rates in the United States largely reflects the interplay between natural economic forces and the actions of the Federal Reserve. At the present time the Fed feels the need to raise interest rates to slow down American consumption in order to offset the assortment of problems we mentioned above. Using higher borrowing rates to solve the inflation problem is a very crude approach when so many of the current underlying causes are the result of circumstances outside the U.S. How well it will work without causing a recession is impossible to know, but we are skeptical.

> ***Expectation:***
> ***Interest rates are likely to rise until the Fed feels that they have broken the back of the inflation trend. Because they don't really control the causes, the amount by which they have to raise interest rates and the length of time that they will do so, is simply unknowable until more economic events unfold. But since a higher core inflation rate will persist in the meantime, modestly higher rates have to be expected.***

Recession

The last recession of serious consequence was the so-called "Great Recession" of 2008/2009. Since then, Americans have experienced one of the longest economic expansions on record. But this has been accomplished by the addition of an extraordinary amount of debt by both the federal government and the American consumer. America at both the federal government and consumer level has arguably borrowed too much for too long. This means that there are vast amounts of interest that have to be paid on all this debt. As a result, any efforts by the Federal Reserve to push rates higher in the interest of slowing inflation will also push borrowing costs up for all the borrowers. Consumer spending drives 70% of our economy. Higher interest rates will slow the consumer. They are already hitting home building and other industries dependent on borrowing—autos and RVs for example. A recession seems almost certain to us as a result. Counterbalancing this to a degree are indications that many high-end consumers are still in very good financial shape, thus keeping the economy from a severe decline.

> ***Expectation*:**
> ***A recession seems almost inevitable. But a weakening economy does not impact all parts of the economy to do same degree. This becomes an important consideration in building equity portfolio strategy, especially when equity valuations in the market are becoming so wildly varied. There are opportunities that are already emerging in some sectors of the economy.***

Valuation

This valuation comment is in here because everyone investing in the equity markets is obliged to have an opinion about valuation and whether the individual stocks or broad market are expensive or cheap. The problem is that in this market cycle so much of the money that is traded is being done so on a mechanical or quantitative basis. All of this trading based on momentum, computer algorithms or chart reading has left the investment world with a woefully small percentage of investors that legitimately understand fundamentals (a la Warren Buffett) and therefore value investing. With so many investors playing "blind-leading-the-blind" any opinion about valuation is overwhelmed by the diverse actions of the short-term traders. As a result, it is a mistake to spend too much intellectual horsepower thinking about broad market valuations when so many macro events are changing the outlook weekly. We would prefer to focus on two narrower aspects of the valuation question. First, with the large decline that the equity markets have already experienced, valuations in general are no longer unreasonable. Second, this momentum traded world with its highly mechanical participants has crushed some market sectors and created some exceptional individual bargains.

Expectation:
Seldom has there been a time when an investment process that emphasizes fundamentally based value investing been so well positioned for potential success. It's not the value of the broad market that will determine success. Rather, it's the exceptional bargains that have been created among the momentum "trashed" stocks as they were hammered in the last twelve months. This indiscriminate abuse of some very good companies now offers us, as investors, what is easily the best opportunity for value investors since 2008/2009.

SUMMING UP

Economy

1. The economy is clearly decelerating. Second quarter GDP is likely to be weak or even negative.
2. Consumer confidence is extremely low. Many consumers are very uneasy about the economy, and many are concerned about the direction the country is going, but…….
3. Consumer balance sheets on average are strong according to national authorities like the CEO of Bank of America, but there is significant variation between income levels. The strength is largely with those who are fortunate enough to be among the upper half of wage earners, especially those with white collar jobs that continued throughout the pandemic.
4. Home equity values are solid provided that mortgage rates don't keep rising. Real estate excesses are nothing like the idiotic behavior that was apparent at the peak of the real estate foolishness in 2007.

Stock Market

1. Market indices are down to reasonable levels.
2. The large role of momentum trading has severely depressed the stocks of economic sectors that are currently unpopular, creating compelling bargains.
3. The crypto currencies are getting destroyed. That is a good thing. They're a sham—always have been.
4. Many of the popular measures followed by market technicians are showing that the equity markets are oversold, suggesting the potential for a sizable rally.
5. The deteriorating economy, however, will limit the upside of any rally and the likelihood of further economic weakness could lead to additional declines.

The old bull market is over. There will be no restart of the past bull or another bull market any time soon. But with the extreme selloff of the last couple of months we think it's important to be open to some slightly more positive possibilities.

Some individual stocks have become so inexpensive that a little buying is in order in coming weeks.