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The HBWM Quarterly Roundup

1Q 2024

Market Overview

The powerful rally that began in October last year continued through the first quarter, leading to the best first quarter returns for five years. The S&P500 gained over 10%, to a record high. The MSCI World gained over 8%. Strong US economic growth, enthusiasm about AI, and hopes of a soft landing with multiple interest rate cuts were the commonly attributed drivers, as they were in the previous quarter. Through the quarter the rally broadened beyond the big tech stocks, and international markets, led by Japan, outperformed US equities.

> The broader rally in equity indices had reflected hopes for a wider economic upcycle. But stalled equity indices late in March now reflect its narrow foundation on expansive fiscal policy.

Behind these headlines the drivers of the rally changed, and by late March its progress stalled. Inflation data was discouraging, as inflation stopped falling. Prospects for interest rate cuts diminished in tandem, with some commentators even predicting none in 2024. We do not forecast interest rates, but we think it is reasonable to anticipate that rates do not fall much this year, in accordance with our views last quarter. We observe that the composition of inflation has been changing, from goods to services as wages rise, shelter rises, and energy prices rise supported by higher oil prices. It is important to note that lower income brackets of the population are particularly sensitive to fuel, shelter, and food costs, which make this a political problem.

The magnificent seven tech stocks no longer performed as a group as investors made distinctions between them. Nvidia and Meta rose strongly on AI enthusiasm. Tesla fell sharply on slowing sales and canceled product releases, facing headwinds in China from stiff competition. These comments can also be applied to Apple. For the tech group, physical choke points became more apparent as the rush to build data centers for large language model training led to competition for electricity and water. The limitations of our current generation and distribution capacities are in the spotlight.

Long interest rates rose. The price of gold rose, despite higher rates and the strong US dollar. Oil and other commodity prices rose (especially cocoa beans, sadly for chocolate lovers). Higher interest rates and higher energy costs are a powerful unfavorable combination for stock markets. These observations are all at odds with the benign scenario of only a few weeks before. In our opinion, the flip-flopping of market views is symptomatic of the fact that the macroeconomic setup is extreme, with no parallels in history. Now that rates are higher, and likely to stay higher for longer, how do financial markets exit the consequences of QE defined as all-time high debt levels as the consequence of ultra-low interest rates?

Geopolitical risks also intensified, whether in the hot wars of eastern Europe and the Middle East, or in the cold trade war with China, with tariffs and protectionism on the rise. We discuss this later in this letter.

Investors entered the second quarter a lot less confident than they were only a couple of weeks before. The broader rally in equity indices had reflected hopes for a wider economic upcycle. Stalled equity indices late in March now reflect their narrow foundation on expansive fiscal policy, especially in the US. This is a dilemma.

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Investment Outlook

Even though the market zeitgeist has shifted in the course of the first quarter, none of the investment questions posed in our last letter is much closer to an answer. This letter will focus on where our thinking might evolve based on events. Overall, our investment outlook is the same. Investment discipline is to constantly revisit and test our ideas. An absence of change is symptomatic of conviction, not stasis.

We are confident in our views as more and more well-known commentators (even Jamie Dimon and Larry Fink) begin to refer to long term secular and structural factors, underlining their importance, and their inconsistencies with short term financial market outcomes. The balance between investment based on short term tactical trading and investment based on strategic considerations is shifting, we believe in favor of the latter.

It is worthwhile revisiting those questions.

- Is inflation beaten or reduced to lower, but sticky levels? If the latter, can interest rates be cut significantly? If not, how will higher interest rates (compared to the last decade) play out across the economy and financial markets?
- Will loose fiscal policy affect interest rates? Will financial markets discipline loose fiscal policy?
- What is the interplay between the physical and the digital economy? Is the absence of capital investment in the physical economy a bottleneck?
- Is the energy transition, which requires huge capital investment, both a driver of the capex cycle and a bottleneck?
- What are the implications for margins and profits if the capex cycle accelerates?
- How realistic is it to assume that AI can significantly enhance productivity in and of itself, and in the face of physical economy bottlenecks?
- Financial markets have so far turned a blind eye to deteriorating geopolitics. Can they continue to do so?
- Will the global election cycle and domestic politics matter for investors?
- Our incremental views are set out under the broad headings we used last quarter.

Financial Conditions

High public spending is undoubtedly stimulating economic growth, and therefore inflation. High public deficits can cause fixed income markets to swoon. Although there is no sign of this yet, the link between deficit spending, inflation, and interest rates is the reason for which some observers point to the fragility of economic growth in the US. This is a negative asymmetry.

In contrast with the beginning of the quarter, financial market views are now that inflation is sticky, and that interest rates will not be cut much this year, if at all. Higher interest rates will therefore continue to make their way slowly through the economy. Higher rates for longer are at least a headwind for profits and margins, and with financial assets at historically expensive levels, this is a negative asymmetry. If interest rates at these higher levels impair leveraged assets and over-indebted companies, and cause economic and financial stress, rates would be cut. This too is a negative asymmetry, both because financial markets would be stressed and because inflation could accelerate again. If inflation stays sticky, and the economy slows as the slowing global economy impacts the US, stagflation is another possibility.

In credit markets, there are signs of growing pressure in credit card debt and auto loans. Mortgage rates are the highest for a generation. For the time being, it seems that private credit, which is not subject to the pressures of secondary market prices, may have been a viable alternative source of finance as banks restrain lending. The question now is whether all sorts of private financial assets can continue to avoid the rigors of marking prices to market. The phenomenon of adding leverage to already leveraged assets is only of very finite utility and perhaps a symptom of stress.

> Little by little asset prices are becoming subject to the discipline of the hard information based on the reality of a higher interest rate regime resulting from continuing inflation and lax fiscal policy.

Little by little asset prices are becoming subject to the discipline of hard information based on the reality of a higher interest rate regime resulting from continuing inflation and lax fiscal policy. And since we believe that central banks would like to maintain positive real interest rates, it is unlikely that real interest rates return to zero, or lower, other than in the case of financial and economic stress.

Globalization

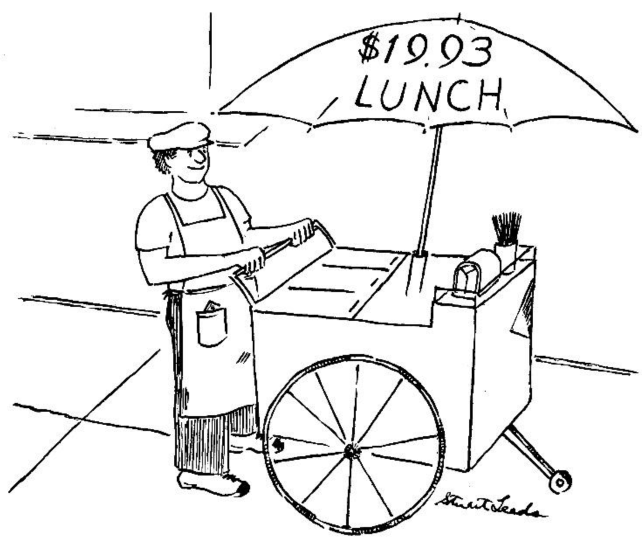
Evidence of headwinds has accumulated. Chips, EV, industrial overcapacity in China were all hot political topics in the quarter. It is possible that the most important element may be labor, either through access to global capacity or through immigration. Labor markets are tight by any measure. They may become even tighter as the structural trends of the last thirty years reverse. Immigration, whatever the societal challenges, has the economic advantage of supplying the labor market (15% in the US) and keeping wages low. The control of immigration may also be an economic headwind. These headwinds are inexorable and slow moving and will remain an investment consideration for some time.

Big Tech & AI

As discussed at length in our previous letter, the headline issues have been further confirmed by developments in the quarter. Succinctly, these are direct competition between the big tech companies on the AI battlefield, access to data sets and issues of data ownership, access to scarce power and water for new data centers, growing calls for regulation, and, for investors, their heavy weight in equity indices together with indexed investment. Set against these forward-looking considerations are the history of high levels of growth and high levels of cash. The balance between the past known factors and the future unknowns is delicate. The latter are certainly a new set of business challenges for the management of these companies to deal with.

Tesla's sharp reversal is worth a few words. It has changed from being perceived as a technological darling in EV, to another maturing participant in an industry that has always suffered from overcapacity and intense global competition, and which suffers from these even more as new Chinese manufacturers have become global competitors. Ignoring the fact that, apart from government subsidies, the case for EVs is not completely compelling, the investment case for Tesla relies on it being able to innovate to extreme levels to regain the lead that is now eroding. It is extraordinary for a relatively new and highly successful company to be in this position so soon.

The broader investment point is that investors have been able to ignore competition as big tech companies grew within their own verticals. That may no longer be the case, and if so, the investment consequences may be very interesting. These companies are very determined and extremely well resourced. That will not guarantee any outcomes, but it will ensure that competition, if it ensues, will be fierce and sustained.



Energy

The energy transition alone, even if political objectives for it are being pushed back, is ushering in a period of high and sustained capital spending, at odds with nearly thirty years of relatively less capital spending, other than in technology.

More and more evidence is gathering of the bottlenecks in the intersection between digital technology and the physical economy. Power and water availability are critical constraints for the build out of more and larger data centers, especially because the size of datasets is the nexus of competition between AI actors.

Another real constraint in both electricity generation and distribution and the oil and gas industry is the aging and declining current workforce and the future availability of skilled engineers to realize the necessary capital investment. Labor costs will inevitably rise.

Almost certainly higher long term energy costs will have a profound negative effect on economic activity, productivity, and returns. This is hardly being discounted by financial markets at high valuations outside the energy complex. This is another inexorable and slow-moving investment consideration. Our views here remain in place.

Geopolitics & Politics

Investors have been happy so far to stay calm in the face of political developments, even those as severe as current events in the Middle East. The fact that political developments, both international and domestic, haven't yet had big investment consequences doesn't mean they can be ignored as investment factors.

At the time of writing the crisis in the Middle East has become much more serious. Even though the short-term financial market reaction has, as has been the case for many years, been relatively subdued, we think that great caution is necessary. We are not geopolitical experts, but we can think about the motives of the various proponents.

This is the first time that Iran has attacked Israel directly from its own territory. Iran's calculation may be that Israel has been losing the support of the international community because of the extent its war against Hamas and its effects on the Palestinian people, and that it is therefore more vulnerable. Although this has been a tit-for-tat exchange so far, the potential for Israel to strike Iran again exists. Israel's calculation may be that attacking Iran to eliminate the latter's demonstrably imminent nuclear ability, and in response to Iran's direct attack, may rally international Western support again. Arab countries supporting the Palestinian people and therefore better disposed towards Iran might also modify their position if reminded of the risk of nuclear Iran. At the least, the erosion of goodwill towards Israel, right or wrong, together with the embattled position of its leader, must heighten risks. In the meantime, the war against Hamas has no obvious end. It is not possible to defeat an idea with arms, and as yet there is no better idea. There is no more dangerous enemy for Israel than one with nothing to lose.

Putin's patience seems to be gaining the advantage in Ukraine as US support fades in the partisan political battle. European countries are only slowly taking up the task, but their defense industries are withered from reliance on the US.

As the Chinese economy weakens due to its domestic financial problems, China is trying to boost growth with cheaper exports. The US and Europe are answering with trade restrictions to deal with Chinese overcapacity.

An increasingly confident and decreasingly democratic India fueled by the economic successes of the Modi regime is charting a course independent of the West.

International arrangements are changing because participants in the system are not satisfied. There is no return to the status quo ante.

A final investment thought is that our political economy is now dealing with the unintended consequences of the big structural and secular changes of the last forty years. Here are a few examples with important investment implications.

- Globalization, for example, had the immediate benefit of access to cheap labor in emerging economies. The benefits were cheaper consumer goods for consumers and outsourced low value-added activities leading to high margins and profits for corporations in the developed countries. The emerging countries had rapidly growing economic activity and higher living standards. The unintended consequences in developed countries were greater inequality as returns accrued to capital, and as labor lost bargaining power and jobs. Consumers, having been the source of savings that financed corporations, became borrowers in order to maintain living standards. Corporations, on the other hand, became savers (think of the cash balances of large companies). Overall levels of debt to GDP rose as governments and individuals tried to keep things going.

- Digital technology, another example, came with the exciting promise of efficiency, convenience, and easy sharing of information. This promise has been realized, but we now struggle with data ownership, the loss of privacy, fake news, teenage angst, loneliness and cultural fracturing. In some ways, technology has increased efficiency, but it's also possible that in others it hasn't. Time is like real estate in that it is only possible for an individual to do so much with their limited time, in the same way that buildings can only be built so high. The unintended consequences of AI, the next digital advance, will become apparent in time. For the time being it makes exciting promises.

- Electric vehicles are another example. The excitement of zero emissions at the point of use is being overtaken by interesting data. From mining materials through manufacturing, use including energy consumption to final recycling it can now be shown that EVs do not offer any significant environmental benefits over small ICE powered vehicles. There are clear financial disadvantages in use and ownership. Time since EV adoption has revealed high costs of ownership because of high depreciation, expensive repairs, and rising insurance costs. These are all related to the high proportionate cost of battery packs compared to the cost of the vehicle, their limited useful life (they need to be replaced after about seven years), and their vulnerability to even minor damage which necessitates replacement. These costs are being spread across the entire motoring population as insurance premia rise sharply. It is another element in sticky inflation.

- Electrification and the energy transition, driven by climate change concerns, have paradoxically led to the resurgence of coal for electricity generation, especially in India and China, and even in Western Europe. Limiting capital access to oil companies led to reduced exploration and now to higher oil prices. Building wind and solar generation capacity without attention to distribution and storage capacity in tandem has also led to higher electricity prices. Essential baseload power generation implies duplicated power generation, that by definition only operates intermittently, also leading to higher energy prices. The promise of cheap alternative energy is far from being fulfilled. On the contrary, the complete opposite is true.

Our point is that dealing with these issues has political and investment consequences that need to balance the exciting promises of technological progress.

Portfolio Positioning

Our investment approach is to identify investment asymmetries. We invest in positive asymmetries found in identifiable, favorable structural and secular changes from which portfolio returns can benefit over time. We avoid negative asymmetries, which can be found in stretched financial conditions and where long cycle changes slowly and inevitably impact consensus views on the economy and markets. Portfolios are designed to absorb market volatility, which permits our approach to take focus away from attempting to trade around market changes in the short term. Our asset allocation model, which reflects our aggregate views on asymmetries, has so far successfully limited downside risk.

We focus on long cycle change in order to position portfolios to gain advantage from long wealth creation. The transition we envisage is gathering pace. Mindful of risks to the status quo, we're building portfolio positions in ideas that we think will benefit from the following winds of the new long cycle which will define the investment context of the next decades.

- We do not believe the next 10 years will be like the last 10 years. We approach the successful investments of the last decade with caution. Some have a place in the portfolio, but not to the dominant extent of the past. (Narrow market leadership is a warning flag).
- We avoid investments where returns are based on financial engineering (leverage, arbitrage, correlations, etc.) rather than wealth creation. For this reason, we broadly avoid investment in the financial industry. Problems may not be systemic, but they are symptomatic of the ways in which higher rates, which are a fact, slowly work their way through the economy.
- We seek genuine innovation (as opposed to growth with no financial returns).

- We favor investments predicated on long-term, prudent capital management, both in companies and financial intermediaries.
- We maintain elevated levels of cash and gold while this long cycle change gathers momentum, and the related geopolitical and political pressures that are its symptoms remain elevated.
- We are comfortable being away from the crowd/consensus.
- We like the energy transition (infrastructure, carbon capture, nuclear), and Japan could be very interesting if they start repatriating capital and companies begin to return capital to investors.
- We also like opportunities available with specialists. For example, those experts that have investment strategies that can benefit from the impact of higher interest rates.

Thank you for your trust and support. If we can help in any way, please do not hesitate to reach out.

Sincerely,

The HBWM Team

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Equity Indices	Price	MTD	QTD	YTD
S&P 500	5,254.35	3.22%	10.55%	10.55%
Nasdaq	16,379.46	1.85%	9.32%	9.32%
Dow Jones Industrials	39,807.37	2.21%	6.14%	6.14%
Russell 2000	2,124.55	3.58%	5.17%	5.17%
Russell 3000	3,012.90	3.23%	10.02%	10.02%
S&P 500 Sectors				
Utilities	333.49	6.62%	4.57%	4.57%
Consumer Disc.	1,485.49	0.10%	4.98%	4.98%
Telco	284.29	4.34%	15.82%	15.82%
Consumer Staples	814.23	3.49%	7.52%	7.52%
Industrials	1,066.71	4.41%	10.97%	10.97%
Technology	3,821.05	1.97%	12.69%	12.69%
HealthCare	1,723.97	2.38%	8.85%	8.85%
Materials	585.16	6.50%	8.95%	8.95%
Financials	701.32	4.77%	12.45%	12.45%
Energy	721.24	10.60%	13.69%	13.69%
Real Estate	248.16	1.77%	-0.55%	-0.55%
US Interest Rates				
3 Month	5.36	-0.33%	0.55%	0.55%
2-Year Note	4.62	0.03%	8.71%	8.71%
5-Year Note	4.21	-0.76%	9.50%	9.50%
10-Year Bond	4.20	-1.17%	8.28%	8.28%
30-Year Bond	4.34	-0.83%	7.81%	7.81%
Commodities				
Crude (WTI)	83.17	6.27%	16.08%	16.08%
Brent	87.48	4.62%	13.55%	13.55%
N. Gas	1.76	-5.22%	-29.87%	-29.87%
Gold	2,229.87	9.08%	8.09%	8.09%
Silver	24.96	10.09%	4.91%	4.91%
Currencies				
DXY	104.55	0.37%	3.17%	3.17%
EUR	1.08	-0.15%	-2.26%	-2.26%
CAD	1.35	-0.29%	2.24%	2.24%
GBP	1.26	-0.01%	-0.84%	-0.84%
JPY	151.38	0.93%	7.33%	7.33%

Source: Bloomberg as of 3/31/2024

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HBMW Quotes of the Quarter

"...If you want to be great in a particular area, you have to obsess over it. A lot of people say they want to be great, but they're not willing to make the sacrifices necessary to achieve greatness. They have other concerns, and they spread themselves out... Greatness isn't easy to achieve. It requires a lot of time, a lot of sacrifices... So you have to have an understanding circle of family and friends...There's a fine balance between obsessing about your craft and being there for your family. It's akin to walking a tightrope. Your legs are shaky, and you're trying to find your center. Whenever you lean too far in one direction, you correct your course and end up over leaning in the other direction. So you correct by leaning the other way again. That's the dance. You can't achieve greatness by walking a straight line."

Kobe Bryant

"There's nothing better than being the underdog. The more people count me out, the more I count myself in. I don't like to show all my cards too early, and that gives me two distinct advantages: my opponents often get the wrong read on me, and I push myself longer and harder. When it looks like you should pack it in but you still dig in anyway, you also pick up a lot of support."

T. Boone Pickens

"The most powerful productivity tool ever invented is simply the word no."

Shane Parrish

"I think if you see the world accurately, it's bound to be humorous, because it's ridiculous."

Charlie Munger

"A record is a record. I don't want it to be the reason people remember me. I hope people remember me for the way I played with a smile on my face, my competitive fire. They can remember the wins but also the fun me and my teammates had together."

Caitlin Clark

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1Q 2024: What Happened and What Mattered

Harvard President Resigns
Claudine Gay, President of Harvard University, resigned after just six months on the job after intense pressure and criticism of her handling of antisemitism amongst students and her testimony during a congressional hearing.

More Boeing Planes Grounded
Following a window blowout on one of its flights, Alaska Airlines announced it would temporarily ground all of its Boeing 737-9 Max fleet until full maintenance and safety inspections were completed on all 65 planes in its fleet. The FAA followed suit and grounded an additional 171 planes across numerous U.S. airlines due to safety concerns.

Patriots & Belichick Part Ways
The New England Patriots long time coach Bill Belichick released a joint statement announcing they had agreed to part ways after 24 seasons with Belichick at the helm. Belichick, along with legendary quarterback Tom Brady, lead the team to 6 Super Bowl wins of its 9 appearances.

Microsoft Surpasses Apple
In January, Microsoft surpassed its rival Apple as the world's most valuable publicly traded company with a market capitalization at $2.887 trillion.

Royals Health at Risk
In January, the British Royal Family announced both King Charles III and Princes of Wales Kate Middleton were undergoing medical procedures for health issues related to cancer.

Republican Field Narrows
Both Florida Governor Ron DeSantis and former South Carolina Governor Nikki Haley announced they were dropping out in their race for the Republican nominee for President.

Carlson Interviews Putin
Russian President Vladimir Putin sat down for a two-hour interview with Tucker Carlson, a somewhat surprising move given the Russian president’s typical rejection of American media.

Chiefs Win Super Bowl LVIII
The Kansas City Chiefs defeated the San Francisco 49ers 25-22 in overtime to claim their third NFL championship in five years.

SS Arlington Found
The SS Arlington, a Canadian merchant ship that sank in Lake Superior in 1940, was located by a shipwreck hunter in February.

Democrats Flip Santos Seat
Former Rep. Tom Suozzi (D-NY) beat republican Mazi Pilip by about 8 points to win the special election in February to replace the seat of ousted Rep. George Santos (R-NY) in New York’s 3rd Congressional District.

Fed Signals Interest Rate Cuts in 24’
In December, the Federal Reserve kept interest rates unchanged but projected three rate cuts in 2024.

Santos Expelled
New York Republican George Santos was formally expelled from Congress following a number of criminal charges and financial misdeeds. Santos became the sixth House member to ever be expelled from Congress in U.S. history.

Greece Legalized Same-Sex Marriage
In February, Greece’s parliament legalized same-sex marriage making it the first Orthodox Christian country to do so.

Capitol One to Buy Discover
Credit Card giant Capitol One announced it would purchase rival credit card issuer Discover Financial Services for $35.3 billion in stock. If the deal is cleared by regulators, it would create the biggest credit card lender in the country.

Alabama Rules on Frozen Embryos
The Alabama Supreme Court ruled that frozen embryos created via in-vitro fertilization are children and therefore protected under state law.

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