



October 25, 2023

"The problem with socialism is that you eventually run out of other people's money."

– Margaret Thatcher
Prime Minister of the United Kingdom 1979-1990

Dear Client,

The industrial economy continued to contract, yet the seemingly resilient (profligate?) consumer rebounded (from a very minor pause) and retail sales moved back into growth mode during the third quarter. All to the consternation of the economic punditry whose consensus has shifted from hard-landing, to soft-landing, now all the way to no-landing. Yet, what if this cycle is just somewhat different given the Covid shutdown, reopening, and massive government spending? More precisely, what if this cycle is different, elongated for sure, yet still very much a cycle? With ups and then... downs. What if amid persistently high government spending, and the two great spenders (Biden and Trump) the clear front runners for the 2024 election, the bond vigilantes have finally awoken? What if higher rates now force a check on what has (artificially?) held the economy together? What if it all points to a continuation of a stagflationary environment for at least the next few quarters? More on that below, but first, a review of Q3 performance for "primary" assets.¹

Commodities were the lone primary asset class with a positive return in the third quarter. US equities were down -3.2% during the three-month period. Global equities fared slightly worse, down -3.7%. Yet, the most volatile and "riskiest" of assets, commodities gained 15.5% during the quarter.

¹ We refer to US equities, long-dated US Treasury bonds, gold, and commodities as "primary" asset classes borrowing the language of HCWE & Company. The idea is that these four assets best capture two variables that explain a significant amount of asset price movement: global growth (explained by investor risk sentiment) and inflation. This framework is the basis for a permanent portfolio, an "all-season" portfolio, risk-parity, etc. US equities and commodities are "risk" assets, while US Treasury bonds and gold are "haven" assets. The market (or asset class) returns are measured on a total return basis using index exchange traded funds (ETFs): SPY for the S&P 500, ACWI for the MSCI All-Country World Index, GSG for the S&P GSCI Commodity Index, TLT for 20+ Year Treasury Bond index (i.e. "long-dated" US Treasury bonds), and GLD for gold.

Last quarter, it was the reverse: equities were up and commodities down. We speculated at an explanatory narrative, writing, “Perhaps the equity and commodity divergence is because commodities are more immediately economically sensitive; an interpretation consistent with the global economic slowdown seen across manufacturing, industrial production, and country-level gross domestic production.” Hmm. How does that fit with the most recent quarter’s development?

Safe-haven assets were down for the second quarter in a row and the move accelerated. Gold was down -3.8%. Long-dated US Treasury bonds returned -13.1%. The significant decline in long-dated US Treasury bonds is remarkable given that it is thought to be both low-volatility and the safest of safe-haven assets. Furthermore, it was down 31.2% in 2022 for its worst annual performance ever. No mean-reversion yet.

Consistent with the defensive posture we have maintained since late 2021, the Grey Owl All-Season² strategy was essentially flat for the period (down 0.3%).

It is worth noting that the significant selloff in long-dated US Treasury bonds continued for the first three weeks of October (through Friday, October 20). The long-bond was down -5.9% during this period. This dragged equities down too. US equities were down -1.5% and global equities were down -2.1%. Commodities were flat for the period (down -0.4%). Gold has seen a tremendous rally, up +7.1%, but a meaningful portion of that is most likely a flight-to-safety in light of the atrocities in Israel.

Economic Growth

The economic picture, described by charts we have updated and shared for the last several quarters, is more complicated today than it appeared the last few times we wrote. Many of the series we have highlighted appear to be showing the slightest signs of life.

The manufacturing economy did continue its contraction during the third quarter, yet, even here, the trend may have changed (it is contracting at a slower rate). Recall the US ISM Manufacturing Purchasing Manager Index (PMI) summarizes in a single data point the state of the US economy. The PMI is a “diffusion index” which aggregates survey data from decision makers throughout the manufacturing economy. The questions are around the managers’ expectations (e.g. “do you plan to acquire more or less inventory next month compared to this month) and are thus a leading indicator of economic activity.

² Despite the generic and frequent use of the term, we renamed our strategy Grey Owl All-Season after Bridgewater Associates requested we do so claiming it conflicted with a strategy they call All-Weather.

The PMI has been decelerating since March of 2021. It entered contractionary territory (below 50) in November 2022 and continued lower to 46.00 in June 2023. For now, this is the cycle low. While still contractionary in September at 49.00, this index has been climbing for three months.

US ISM Manufacturing PMI (I:USPMI)

49.00 for Sep 2023

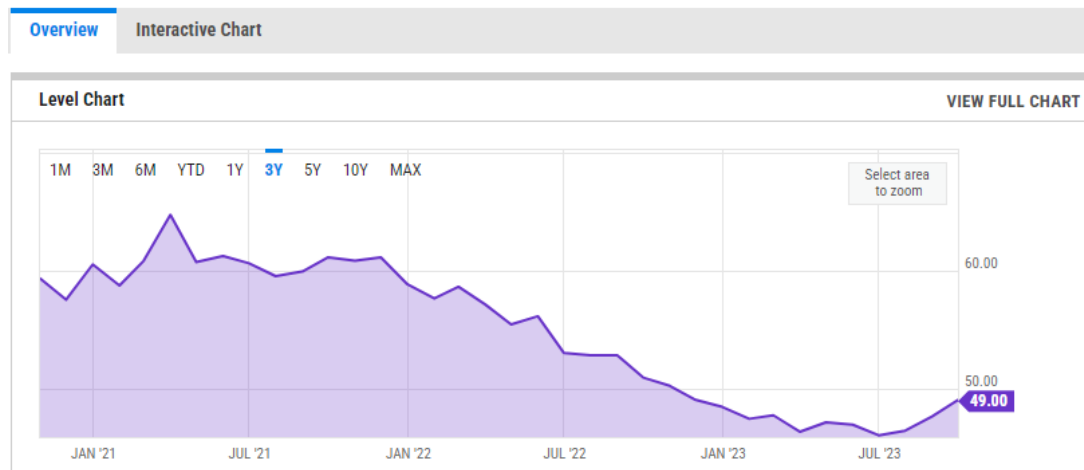


Figure 1 – US ISM Manufacturing PMI monthly³

Industrial production shows a similar pattern. Its year-over-year growth is no longer decelerating, but for now it remains stuck at the zero level.

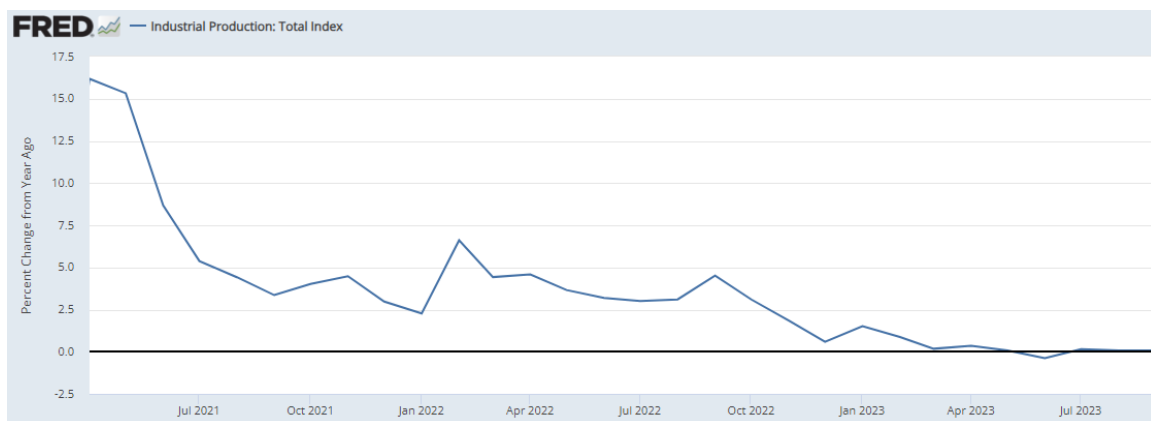


Figure 2 - <https://fred.stlouisfed.org/series/INDPRO>

³ https://ycharts.com/indicators/us_pmi

The rebound extends beyond the manufacturing economy. The Johnson Redbook Index shows a return to year-over-year growth in retail sales beginning in the middle of the summer.

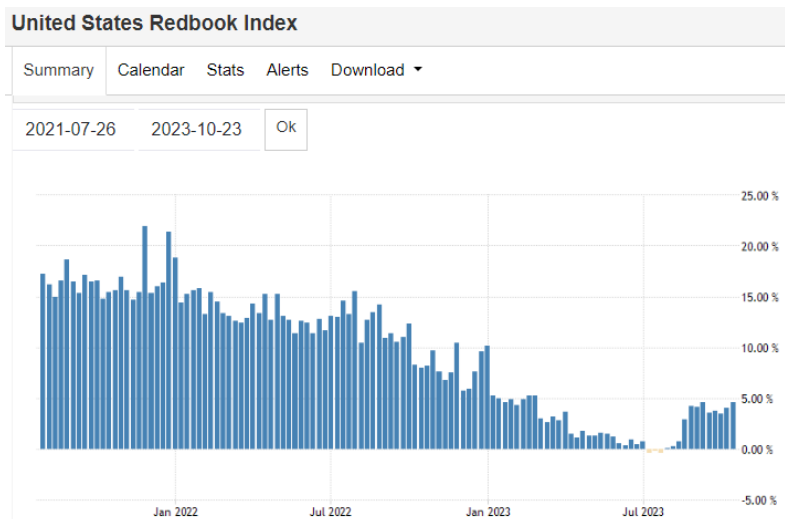


Figure 3 - <https://tradingeconomics.com/united-states/redbook-index>

Did the US economy already experience a “soft-landing?” Has the rebound begun? Perhaps, but it seems unlikely. More likely is that unsustainable government and consumer borrowing has extended the cycle.

Borrowing to Spending

After modestly contracting from the 2020 Covid stimulus, federal government spending resumed growing on a quarter-over-quarter basis in the second quarter of 2021 (from a level significantly higher than the pre-Covid baseline).

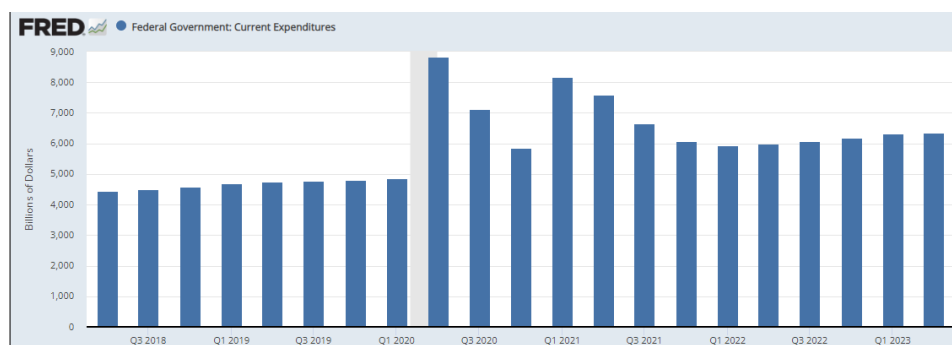


Figure 4 - Federal Government: Current Expenditures, Billions of Dollars, Seasonally Adjusted Annual Rate;
<https://fred.stlouisfed.org/series/FGEXPND#0>

How is all that government spending possible? Federal debt increased by over 50% to \$32.2 TRILLION dollars in just the last 5 years.

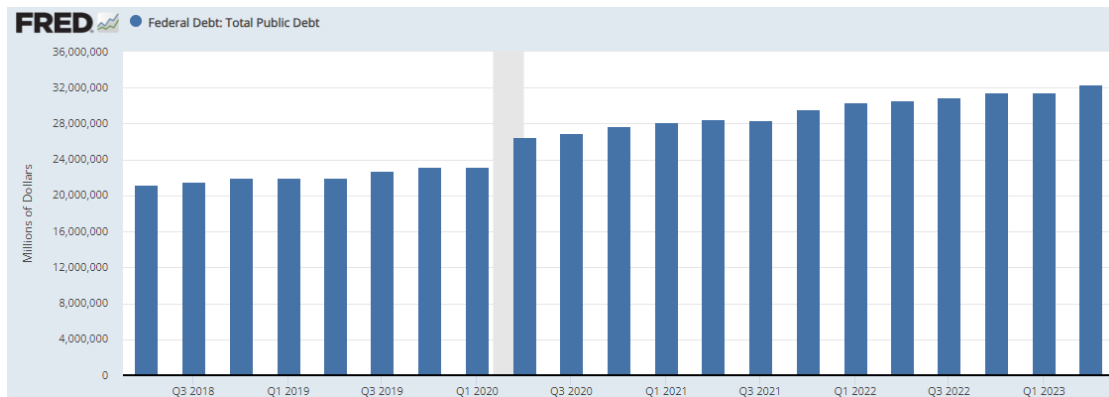


Figure 5 - <https://fred.stlouisfed.org/series/GFDEBTN#0>

How long can this continue? Who knows for sure, but some of the last remaining pandemic era programs are finally winding down.

It's not just the government that is borrowing at an accelerating pace. Consumers have followed the government lead with credit card balance growth over the past few quarters the highest in twenty years.

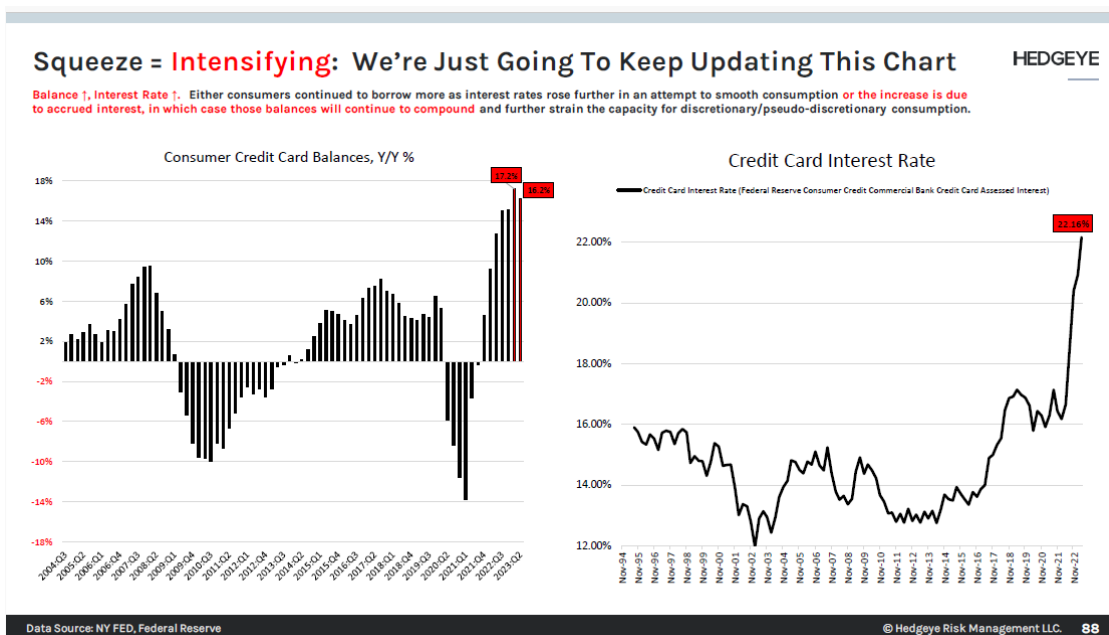


Figure 6 - Hedgeye Quarterly; https://app.hedgeye.com/feed_items/all?page=1&with_category=74-macro-pro

And, for 80% of US consumers, all the Covid-era savings are gone. Debt is up and savings are down.

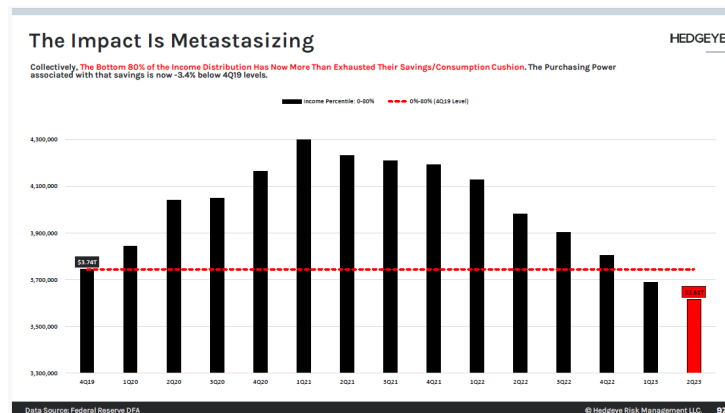


Figure 7 - Hedgeye Quarterly; https://app.hedgeye.com/feed_items/all?page=1&with_category=74-macro-pro

Can the government and consumer borrowing continue? For sure in the short run. But, not forever. And, pressure from higher interest payments and a resumption in student loan debt payments are now beginning to exert pressure.

Inflation

Last quarter we wrote that inflation **may** be reaccelerating. We showed the below chart highlight that “since the beginning of May both commodity prices (orange in the chart below) and the 5-Year Breakeven Inflation Rate (blue in the chart below) have been creeping higher.”



Figure 8 - www.tradingview.com

What was a creep higher became a much more definitive and aggressive move in the last few months.



Figure 9 - www.tradingview.com

Market Signals

Global equities have been under pressure, again, since the end of July. The Russell 2000 (small capitalization index) is now down year-to-date. While most acute in small caps, the weakness is broader. On a price basis, both the Dow Jones Industrial Average and the MSCI USA Equal Weighted Index are down year-to-date. This is not a healthy market. Lowry's Buying Power and Selling Pressure calculations collect this information into two summary statistics that show sellers are in control and caution is warranted for now.

Buying Power / Selling Pressure



Figure 10 - <https://www.lowryondemand.com/members/>

Cautious, Yet Open Minded

Since the end of 2021, we have positioned the Grey Owl All-Season portfolio for a risk-off environment. With some important modifications that action largely continues, as our “safe haven” positions, particularly our cash allocation and precious metals remain large. Today, the cash position yields approximately 5% annually. For the first time in fifteen years, it pays to be cautious.

The equity market rally from oversold levels in late 2022 was heavily concentrated in the blue-chip of the current blue-chip names. Since the end of July that rally has been challenged. Our equity market exposure is therefore modest. Given the acceleration in inflation we have held and continue to hold exposure to commodities and energy producer equities. In addition, we are long-term optimistic about both Japan and India where their economies are growing.

The US economy has held up better and longer than most believed possible. While the evidence points to unsustainable borrowing as the most likely explanation, it is impossible to say when it would truly become unsustainable. As Lady Thatcher explained, in socialism you do eventually run out of other people’s money, but it is very hard to predict when. In addition, the innovative spirit of entrepreneurs in the US economy has cured many ills and an AI-driven productivity miracle (for example) is certainly possible. We are cautious for now, but open-minded and ready to adjust.

As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC

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