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Summer Cocktails, White Sneakers, Nvidia: It's Back to Schooling

While the beach version of SoCal has had an epic, non-marine layer summer, it seems to have been enjoyed by few locals who instead violate the cardinal rule of adult life without children living at home and nevertheless travel to Europe in summer. We haven't missed you.

But occasionally we get the Pineapple Express – which is actually a weather condition, not a new strain of weed – and somewhat of a metaphor for markets this past summer. Another version of "OH MY GOD MARKETS CAN GO DOWN," and yet the world manages to trudge its way out of bed and get on with its life, which this summer seems to consist of hoisting anti-Semitic flags or ranting about the two usual suspects vying for the title this November. In case you were wondering, foreign exchange markets are the largest dollar pools in the world, and they work on a complex counter-party system involving high degrees of leverage. New small pebbles – or elections – thrown in the middle of a pond that has seemed placid "forever" has often been the forebearer of unpleasant financial market activity. Nothing new here. Things will change again, which is why one should always be careful of crowded and arguably overvalued assets with trailing measures of historically low volatility. And as Buffett noted in his 2024 letter: "Today's active participants are neither more emotionally stable nor better taught than when I was in school." Cue to old people nodding. Gin and Tonic.

But as we are all supposed to know, the modern history of financial markets seems to be entirely about short-term changes in Federal Reserve policy. To steal again from Byrne Hobart's The Diff: "one weird feature of the global economy is that when it slows, one of the most significant policy responses is to reduce interest rates so American homeowners can afford to consume more of what the rest of the world produces." And this clearly benefits a certain class of folks, who seem unlikely be the same people whose financial struggles are supposedly crushing the Dollar Generals of the world. DG noted in its earnings that based on its surveys, its core customers 1) are having trouble stretching budgets to the end of the month, 2) are sacrificing purchasing basic necessities, and 3) anticipate missing bill payments in the next 6 months. To boot, "the economy is waiting for lower interest rates." I would note, that online Chinese virtual store Temu has rocketed from zero to high teens share of "crap-stuff," which naturally was overlooked on the earnings call.

On the other side of the tracks, and throwing more confusing potions in the cauldron, we have the massive blob of "AI-Spend" which is not only has a non-zero probability of throwing off analysis of aggregate economic activity, as well as boosting the spend propensity of those with massive positions in the stocks that have benefitted from said blob. Sustainability uncertain, but we are relieved the Fed has this figured out. Jack Daniels, rocks.

So whining about what one might consider a ridiculous sensitivity to short term interest rates is some combination of correct, a false attachment to life as it should be vs. what is, or some particularly scary scenario that suggests we as a world are truly overleveraged everywhere we look and thus rely on a series of unelected people with mysterious powers of clairvoyance never before available to anyone that preceded them in the seat of monetary power. It is also odd that the Fed's annual Jackson Hole gathering for the academic monetary elite and their followers on, has been ground zero for insane inflation. (see Village Cafe to Wes Edens condo trade). But clearly, score one for the Feds this time who saw a Covid supply chain inflation spike and amazingly reacted well to it. But who is to argue with the statement that those in charge of making policy tend to have a rather tenuous relationship with said policy's effects on people on the ground. To quote Mr. Powell in his own words:

"The limits of our knowledge — so clearly evident during the pandemic — demand humility and a questioning spirit focused on learning lessons from the past and applying them flexibly to our current challenges."

In the words of Munger, we have nothing further to add. All a sentient investor can ask for is to set a non-stupid course that allows the "market" to operate and enable economic forces to have a market-derived guide toward the cost of capital. And then leave us alone. We recognize how quaint a notion that is. Hemingway Daiquiri. Shaken.

But the Church of What Is Working always packs the house. After the world didn't end in July, most large tech is back where it was and credit spreads are generally back to being crazily tight – in this writer's humble opinion – despite the financial world's obsession with the headline "creditor on creditor violence," which I will admit is good clean fun. The Caesar's Palace Coup remains the highly readable bible on this topic for civilians. The question remains – are we really going to have a serious problem with banks/credit? And will there be any sense of historical rhyming as an over-weight on highly favored assets – this time Tech/Credit/Private Assets – inevitably unwind? And does it just ruin the world for the rest of us or does it look like 2000-2002 where there is a containable massive shift into "other" assets. Après-ski, we have a 9% weighting in what we might call "leveraged" equities that haven't done well and represent our interest in these issues. Maple Syrup Whiskey Sour.

Despite our complete inability to consistently time macro-economic changes – a very basic human trait in case you wonder somedays how you personally fit in with how you perceive the rest of humanity – we do read and think a lot about what is "defensive vs. cyclical" in portfolio building and what valuation is embedded in current pricing. One thing we have noted: there has been a massive swing into power assets under the premise that AI is going to be a bonanza for utility growth and investors. All else being equal, if a utility is approached by a 30% increase in demand and requests its regulator for money to build for said demand and whose source of funds will be debt issuance leading to higher rates on a larger asset base designed to deliver an 11% ROE, then voila – buy utilities. What is interesting here, as noted in our CSC blog, is that all else is not equal. Think what you may about this election and your awful choices and the economic idiocy being espoused on both sides; convincing elected regulators that the Scranton Harris's of the world should be paying higher energy prices so that Devour and Conquer Tech Colossus, Inc. can make your phone think for you is going to be a hard sell outside of California where it seems to be going swimmingly well in a one-party town. And note to self: this will be an impending epic bout of corporate phony green-washing as there is nothing in the wind and solar playbook remotely close to cheap and always-on energy necessary to run massive data centers, which is why we have Iceland and Finland. In fact, we are specifically seeing "fronts" created with fancy names to sign contracts hard in the middle of coal country, which is backed by utterly rational economic thinking. However, it seems like a hard sell or duplicitous coming from the great fonts of goodness running the tech world. But things change: if the shining moral star of Starbucks will give its new CEO enough miles for commuting purposes to compete with Taylor Swift's corporate jet usage, maybe things will be different?

Of course, a rational mind might run for the economic hills with what we will be seeing daily until the election – and likely after it – but rational minds have a long history of being wrong on macro-events. We have had these damn "election things" every four years for a really long time and somehow work manages to get done and progress ensues. And the Dow Jones is…40,000. Paying attention to the valuation of businesses that will still "be here" and getting dumped out in the monthly wash seems to us a more thoughtful way to spend our time, despite the fact that the jury seems to be out this year on whether that is a profitable endeavor. Mojito.

Judging by corporate results from the world's spirits makers, what most people aren't doing this summer is drinking a lot, which remains a confusing sign as to where economic winds are blowing if we are to paraphrase the Christopher Hitchens rules of drinking: "Don't drink if you have the blues: it's a junk cure. Drink when you are in a good mood." We posit this as a long-standing rule: properly identified cyclical problems are inherently buyable. And hopefully buyable "nearish" bottoms vs. right in the middle of a solid recession-driven drubbing. A long-term EV/Sales analysis is helpful as gauge for where one is in an economic cycle, as earnings and cashflow are almost always more volatile than the topline. While recent market strength seems to dump on the idea that there may be some probability attached to less buoyant economic times, we have a list of fully researched companies with a reasonable valuation attached that we can easily bring forth on that rainy day. Aubert Chardonnay.

So we worry top down, but invest bottom up. As far as "stuff we are doing," we have extended our somewhat successful investment to date in Research Solutions (ticker: RSSS) in the "workflow efficiency solutions for R&D-driven organizations in life sciences, technology, and academia worldwide" to a larger version in Clarivate (ticker: CLVT) which is an impressive set of financials emerging from the true idiocy of a SPAC concoction. A recent change in CEO, an interesting host of new shareholders, and some intriguing valuation math. Note to reader: while we have a ton of internal work, we don't do 70-page pitches for the world at large. An "investor" should be open to participating in an interesting network of idea generation, but for God's sake do some of your own work. The Honey Deuce.

We have done some tactical dancing which can be available to smaller pools of capital and have wound up – again – with a new position in Advance Auto Parts (ticker: AAP). This is a classic value dilemma in which you have a cheap security with new management in what should be a good business with two insanely good competitors. A return to "average" execution over three years makes a lot of money. We have a balance sheet now that supports the case that our downside suggests boredom. Will see you in three years with a verdict and a 2000-word recap. And we beg you to read our "bookish" piece on Motorcar Parts of America (ticker: MPAA) here, from which spawned AAP. We are running with this crazy notion that if we dumpster dive X company or industry, we should expand the periphery of what we have learned into other opportunities.

We remain committed in a focused manner to manage and develop new relationships with like-minded partners who share the idea that less efficient markets mean more opportunities that are less market correlated (sometimes infuriating). We maintain an SMA structure, our Cove Street Partners LP, and from time to time, some very interesting SPV opportunities. We have a large established body of historical work in what remains a mostly unfollowed and unloved world that is not easy to wake up into and be capable.

We are having an "unproductive" year of performance year to date, which neatly quashes a lovely narrative of our three-year rebound proving that index nonsense and macro yack matters not if you can focus properly. But running focused portfolios is designed for client outcome at the expense of industry success, a trade-off accepted a long time ago.

We are always willing to discuss the daily joys of the investing with like-minded partners. Old Fashioned.

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