



Horizon Kinetics – Market Update (3/20/2020)

The market volatility we're now experiencing is a reminder to all investors and business managers that risks, known and unknown, must be considered at all times. Some time ago, we had identified certain risks that we believe were not fully appreciated in the marketplace, and positioned our portfolios accordingly. While these risks are in fact beginning to manifest themselves in the market and global economy, security price behavior at this moment does not reflect the business attributes or values of individual companies or sectors. At the moment there is little differentiation in the stock market between a good business and a bad one, between one that is cheap or expensive, between companies that will suffer in the coming period and those that will benefit. In part, this is because securities are largely being sold in index fund format, because that is how they are held, so liquidations impact all the securities in those baskets. As to non-indexed securities, when investors require liquidity, everything is fair game. Correlation is not causation, particularly during irrational selling.

The current trading prices represent immediate liquidity needs, not the period after. We believe that this is the short-term reality, but will prove to be temporary. In order to understand our outlook and positioning, we believe that various risks warrant discussion.

The portfolios were positioned at the outset of the year for two distinct risks:

- I. Implications of Inflation/Low Interest Rates
- II. Market Structure of Indexation

Financial markets have consistently dismissed any negative implications from ultra-low global interest rates, which have persisted (recently intensified) in most of the developed world for over a decade. The first consequence of these policies is a subtle, yet pernicious debasement of savings. This is a lack of real yields available in low-risk fixed income securities that millions of people rely upon to fund long-term retirement expenses. This problem has been obscured by rapidly appreciating equity markets, but has likely resulted in allocations for many that are higher risk than prudent. The government's preferred measures of inflation (CPI and PCE) never consistently exceeded 2% during this recovery, but these metrics fail to incorporate financial asset inflation in addition to other substantial expenses (like private education tuition and medical care). A different story is told by money supply growth (M2), which was expanding at a 6% rate throughout this period. Even amidst a record stock market advance, at the end of 2019, the market priced in an assumed inflation breakeven of only 1.79% based on 10-Year Treasury TIPS. Hence, many investors' "conservatively positioned" portfolios are very vulnerable to inflation (whether it be in reported figures or not).

Inflation appears to be the only viable future for various major economies that are running record budget deficits and holding unprecedented levels of debt relative to GDP/government income. The United States Federal Debt is approximately \$23.5 trillion, relative to nominal GDP of approximately \$21.7 trillion (108%). Meanwhile, the projected federal deficit for 2020 is \$1.1 trillion (over 5% of GDP). Bear in mind, these figures are all **before** the current economic disruption and stimulus packages. The ability of mature developed economies to achieve real GDP growth sufficient to pay down debt is mathematically improbable (near impossible), even before accounting for the demographics of aging



populations. Hence, barring a sovereign default, these countries will be permanently overleveraged. At a certain point, investors will no longer fund these governments at such low rates. The historical alternative for a government paying markedly higher rates that it cannot afford is to print more money. That debases the currency, at the expense of savers, as it inflates the economy and permits borrowers to repay in cheaper currency.

Despite the market movements this year (U.S. 10-Year inflation is now priced at 0.79%), the inflationary inflection point is actually nearing. With the impact of the COVID-19 virus on financial markets and economic activity, the Federal debt leverage is about to balloon to unprecedented levels. Inflows will decline (capital gains taxes, excise taxes, corporate income taxes) at the same time that the balance sheet expands (for unemployment and emergency stimulus funding aimed at stabilizing the incomes of workers). *This almost certainly marks the end of the almost 38-year bull market in bonds*, with profound implications for what recommended bond and stock asset allocations should be going forward.

Once this becomes more apparent to the market, and the short-term crisis abates, investors will want to own “hard asset” oriented businesses that will be inflation beneficiaries. However, these types of companies have been amongst the hardest hit in our portfolio this year, as markets fail to look past the economic slow-down over the next several months. As investors ultimately turn toward inflation beneficiary businesses, though, there will not be enough supply (liquidity), as these – the mining, energy and other such sectors – have effectively been eliminated from the S&P 500 and other major indexes in favor of mega-cap stocks with index-centric liquidity. In this event, such a reversal could be both rapid and of great magnitude.

We believe that these companies have been incommensurately impacted in the markets this year in part due to our other risk: indexation. This severity and speed of the current market contraction can be directly attributed to indexation and passive investment strategies, one of the factors that fueled the surge of the market advance. Passive investments are structured to own a basket of securities that fit certain guidelines, which are often descriptive of a theme or sector, even if not functionally so, and with no valuation or price parameters or assessment of the business quality. In fact, many of the most popular passive strategies have been based on momentum (i.e., buy more of what is going up). This resulted in highly concentrated performance, with the largest companies in the economy driving the index. This is currently working itself in reverse, yet the index leaders are still buoyed, as there are few marginal buyers to support anything but the most liquid stocks. Market panics always flock towards liquidity during the earliest stages of selling, hence the recent mega-capitalization stock outperformance.

As it stands today, there is a very high liquidity premium (i.e. a valuation premium being paid for the most trading volume), which is supporting the market leaders for the time being, but which should ultimately unwind and mean revert. This is readily apparent in the divergence between small capitalization and large capitalization stocks. The iShares Russell 2000 ETF is down nearly 40% this year (as of this writing), while the S&P 500 Index is down approximately 26%. In fact, the passive unwind in small capitalization stocks has been so severe that the current year-to-date performance already eclipses the decline for the entirety of 2008 (-34%), while the S&P 500 decline is still 10% points away



from 2008 (-36%). Ergo, small cap stocks have already priced in a worse market than 2008, whereas large cap stocks are well above this level. It should be noted that in 2008, the S&P 500 Index underperformed the Russell 2000 Index, albeit marginally for the year. The prevalence of passive investing and indexation was much smaller 12 years ago.

In further evidence of a structural weakness caused by indexation, various fixed income ETFs are breaking their NAVs and underperforming the index – something that is not supposed to be possible. We believe that there will be a market structure change due to these destabilizing impacts of indexation, with many opportunities for long-term investors.

New risks introduced in 2020:

- I. Temporary Economic Shut-Down
- II. Energy Price War

The government response to combating the spread of the virus will undoubtedly result in a severe economic disruption – there is no way to currently gauge the magnitude or duration of this disruption. The theoretical impacts can however, we believe, be quantified. Consider this time series (*Figure A*) of earnings that could be representative of a company (or the broader market). The earnings are assumed to grow at 4% perpetually (2% real, after-inflation terms), and discounted back to present value at a rate of 7.5%. The corresponding fair value is approximately \$2,700 seen in the lower left of the chart.

<i>Figure A</i>	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Earnings	\$100	\$104	\$108	\$112	\$117	\$122	\$127	\$132	\$137	\$142
Growth		4%	4%	4%	4%	4%	4%	4%	4%	4%
Rate	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%
\$2,709.16	\$93.02	\$89.99	\$87.06	\$84.23	\$81.49	\$78.83	\$76.27	\$73.78	\$71.38	\$1,973.09

We can adjust these figures for an economic disruption that results in a 10% earnings decline this year (concurrent with a mild recession) and a slow recovery of 2% in the following year, followed by a return to 4% trend in the third year (*Figure B*). This would result in a fairly dire expectation of flat earnings through five years, and not exceeding the current base until Year 6. This results in a fair value of approximately \$2,315, or 14.5% lower than under the original scenario.

<i>Figure B</i>	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Earnings	\$100	\$90	\$92	\$95	\$99	\$103	\$107	\$112	\$116	\$121
Growth		-10%	2%	4%	4%	4%	4%	4%	4%	4%
Rate	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%
\$2,314.95 -14.55%	\$93.02	\$77.88	\$73.90	\$71.49	\$69.16	\$66.91	\$64.73	\$62.62	\$60.59	\$1,674.65

The markets are magnitudes lower than this scenario, particularly small capitalization and value stocks, so we will impose an even more draconian scenario for the economy and market. In the series below (*Figure C*), the earnings are assumed to go to zero this year, followed by a year of profitability equivalent to 10% below the prior peak, only then to resume trend growth. In this scenario, the earnings will not



recover to pre-disruption levels until Year 6, but again the fair value is approximately 19% below the original series.

<i>Figure C</i>	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Earnings	\$100	\$0	\$90	\$94	\$97	\$101	\$105	\$109	\$114	\$118
Growth		-100%	N/A	4%	4%	4%	4%	4%	4%	4%
Rate	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%
\$2,195.03 -18.98%	\$93.02	\$0.00	\$72.45	\$70.09	\$67.81	\$65.60	\$63.46	\$61.40	\$59.40	\$1,641.81

The point of this exercise is to illustrate that businesses (equities) are perpetual investments, and to the extent that disruptions are temporary, the fair values are not overly impacted from short-term events. Of course, this does not incorporate the fact that we believe low interest rates had driven broader market valuations to excessive levels, hence a portion of the market decline may be related to a repricing of risk. Fortunately, our portfolios were trading below our assessment of fair value before this event, so the embedded upside is very material (particularly should we be correct about inflation).

In addition to the passive investing unwind, driving a highly correlated market decline (across virtually asset classes), our portfolios have been subject to mark-to-market losses related to a current disagreement between various large oil producing countries (specifically Saudi Arabia and Russia) . There are many complexities to the recent failure of an OPEC+ agreement, which was aimed at balancing oil market supply to account for the temporary lost demand. In summary, Saudi Arabia pushed for an aggressive supply cut, while Russia opposed a preemptive reduction. This stance resulted in the Saudis not only walking away from an agreement, but also subsequently taking measures to materially increase production and cut selling prices. However, with the near-cessation of international travel and drastic reduction in domestic travel, global oil consumption has just dropped, in which case increased production can't be efficiently absorbed. There has been additional sabre rattling on both sides about future actions and the ability to withstand low prices for extended periods of time, as well as the need to stunt the growth of U.S. shale.

There are many failings to conventional wisdom on this topic and the market reaction. Primarily, neither Russia nor Saudi Arabia are content with current prices, and most importantly nor are their respective allies. Russia can theoretically withstand a downturn longer, in no small part because the Saudis need at least \$80 Brent oil prices in order to balance their federal budget. This situation appears to be untenable both politically and practically. Furthermore, the ability to "stop" shale production is an illusion to the extent that even under a severe downturn in U.S. shale production, prices will eventually increase to far higher levels given the (reduced) supply shock (as it would by definition reduce as much as 5% of global supply). In such an event, newly restructured and recapitalized shale companies can mobilize rigs and production fairly rapidly and inexpensively. Hence, the Saudis will flood the market at cheap prices, only to have shale waiting to return to production once price levels increase again.

In any event, oil companies across the globe have already been reducing their exploration expenditures, such that reserves have been dropping worldwide. Last year, for example, Chevron replaced well less than 50% of the oil it produced. Given that, it is quite feasible that the final outcome of the Saudi



Arabia/Russia dispute will be markedly less production and excessively high oil prices, even to the degree of an oil price shock.

This is not to say that we advocate buying oil and gas drilling companies, as many have high debt loads and a limited ability withstand low energy prices. However, perpetual “non-participating” royalty assets with no debt and minimal operating expenses are the best possible assets to invest through a full cycle—specifically, royalties in the lowest cost and largest basin in the country (Permian) with well capitalized, best-in class-operators (Chevron, Exxon, Shell, EOG). As energy prices recover, activity will concentrate in the best acreage and likely be consolidated by the best operators. Refer back to the hypothetical time series for the broader market—this can be applied to royalties, adjusting energy prices and volumes.

Conclusion

To paraphrase Warren Buffett, *the stock market is a voting machine in the short-term and a weighing machine in the long-term*. We believe that “weight” will be cash flow, and many of the companies in the portfolios will continue to operate effectively and generate substantial cash flow (available to shareholders) for many years. This may prove to be an excellent time to purchase equities, but based on valuations, compounding off the prior index highs will be challenging, and likely modest in real terms, after inflation.

We continue to monitor the market and portfolios and have tremendous confidence in the long-term potential of these investments. Market transitions do not follow a predictable pattern, and deviations are often the most extreme before their inflection occurs. We believe that this process is currently underway, visible in the small cap, value and hard asset underperformance, specifically relative to mega-capitalization technology companies.

We attempted to be brief and concise in this update, and will be communicating regularly going forward. As always, please use us and our research library as a resource to the greatest extent possible.



IMPORTANT RISK DISCLOSURES

This material has been authored by Horizon Kinetics LLC (“Horizon Kinetics”), parent holding company to Horizon Kinetics Asset Management LLC, a registered investment adviser. This information should not be used as a general guide to investing or as a source of any specific investment recommendations. This is not an offer to sell or a solicitation to invest.

Opinions and estimates offered constitute the judgment of Horizon Kinetics and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security, and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable. As always, past performance is not indicative of future returns.

This report is based on information available to the public; no representation is made with regard to its accuracy or completeness. This document is neither an offer nor a solicitation to buy or sell securities. All expressions of opinion reflect judgment as of the date set forth above and are subject to change.

Horizon Kinetics and its employees and affiliates may have positions in securities of companies mentioned herein. All views expressed in this report accurately reflect the research analysts’ personal views about any and all of the subject matter, securities or issuers.

No part of the research analysts’ compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analysts in the research report. Reproduction of this excerpt is strictly prohibited.

©2020 Horizon Kinetics LLC ®