A Tale of Two Markets

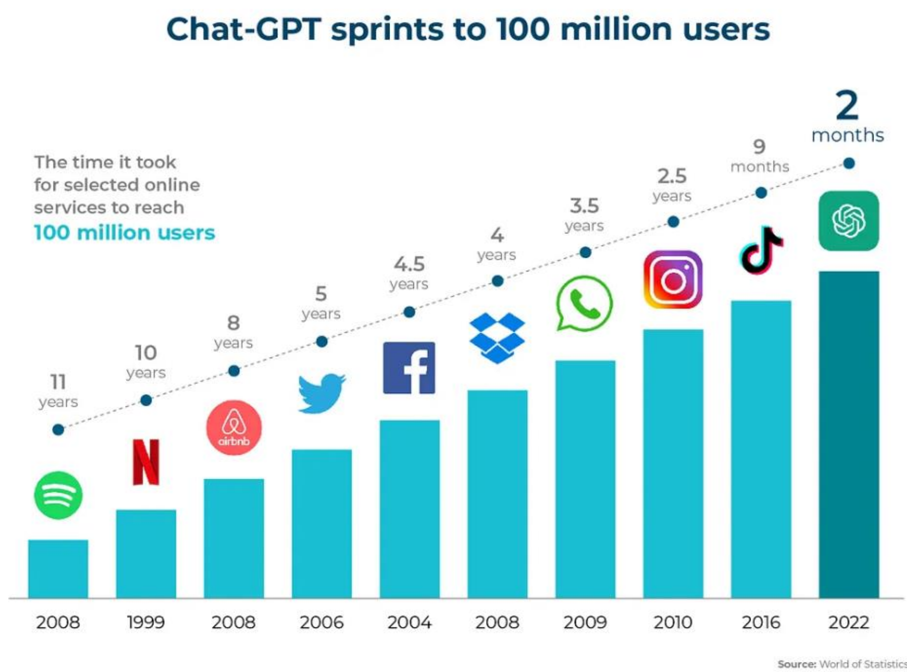
2023 Year-End Client Letter

Happy Holidays from the CenterPoint Strategies team! We hope this letter finds you well and in good spirits.

The financial markets have experienced a range of events and changes over the last year. The inevitable rollercoaster continues – major Wall Street strategists entered 2023 with a near 100% forecast of recession and subsequent hit to corporate earnings. Now, many strategists seem to have jumped on the "soft landing" bandwagon, or in other words, that we will avoid a recession altogether as the labor market loosens up but doesn't result in a radical move higher in the unemployment rate. The US economy has been remarkably resilient, thanks in part to massive fiscal spending in prior years. Luckily, consumers have been largely insulated from the drastic rise in the cost of capital, as they have refinanced mortgages and cleaned up their debt just before the Fed raised overnight rates from the 0-bound range to over 5%. **This indeed has been the single fastest rate rising cycle in history in its magnitude and speed**. The higher the rates go, the more expensive the ballooning US government debt becomes to service in the short, medium, and long term. The good news is, in the near term, this isn't really a huge problem in our opinion. If the economy falls into a recession, tax receipts (the main source of gov. revenue) fall, and entitlements likely go higher which would exacerbate the world's collective debt to GDP ratio. The reality of how the system works today is that the US has the dual privilege of world reserve currency and reserve asset. Put very simply, this means the US has gotten away with exporting inflation to other countries as we import and buy goods from them abroad, and other countries recycle the proceeds back into US treasuries, US dollars and the S&P500. In the longer term, the US will inevitably have to deal with the reality of "taking out more credit cards to pay off our current credit cards", but it seems that other countries will have to feel significantly more pain than the US in the meantime.

After a decade-long stint of near zero interest rates, we entered the period post-COVID in a very different world. Longer dated U.S. Treasuries, the supposed safe-haven reserve asset of the world quickly obligated to this expectation of higher nominal growth and inflation. This caused a fair amount of stress earlier in 2023 on regional and smaller bank balance sheets, or poorly managed banks such as SVB who bought these treasuries at nothing-percent yields. In 2021, 30-year US government bonds were trading at the equivalent of 300x earnings (or internal cash flows), and globally there was over $16 trillion in sovereign negative yielding debt. Bonds were so ridiculously mispriced to begin 2022 it's hard to even put into words. Now imagine being CEO or owner of a small cap company in 2020 and 2021 and you've just survived the largest drawdown in the economy since the Great Depression of 1929 (in nominal GDP terms). You're trying to project and plan out future hiring, capital expenditures, investments, ordering machinery/parts etc. as you see fit with where the economy is in conjunction with the cost of capital. Every single fed governor, or in other words "central planner", is running around forecasting interest rates and inflation to stay low for years and years as the economy needs time to heal. At the same time, Congress is approving multi-TRILLION-dollar relief spending bills. Rates only had one way to go… a lot higher to reflect the helicopter money injected into the real economy. It's too late for the small business owner to put the plans into effect in finality after the cost of capital available goes from 5% to 12% in a matter of 12 months.

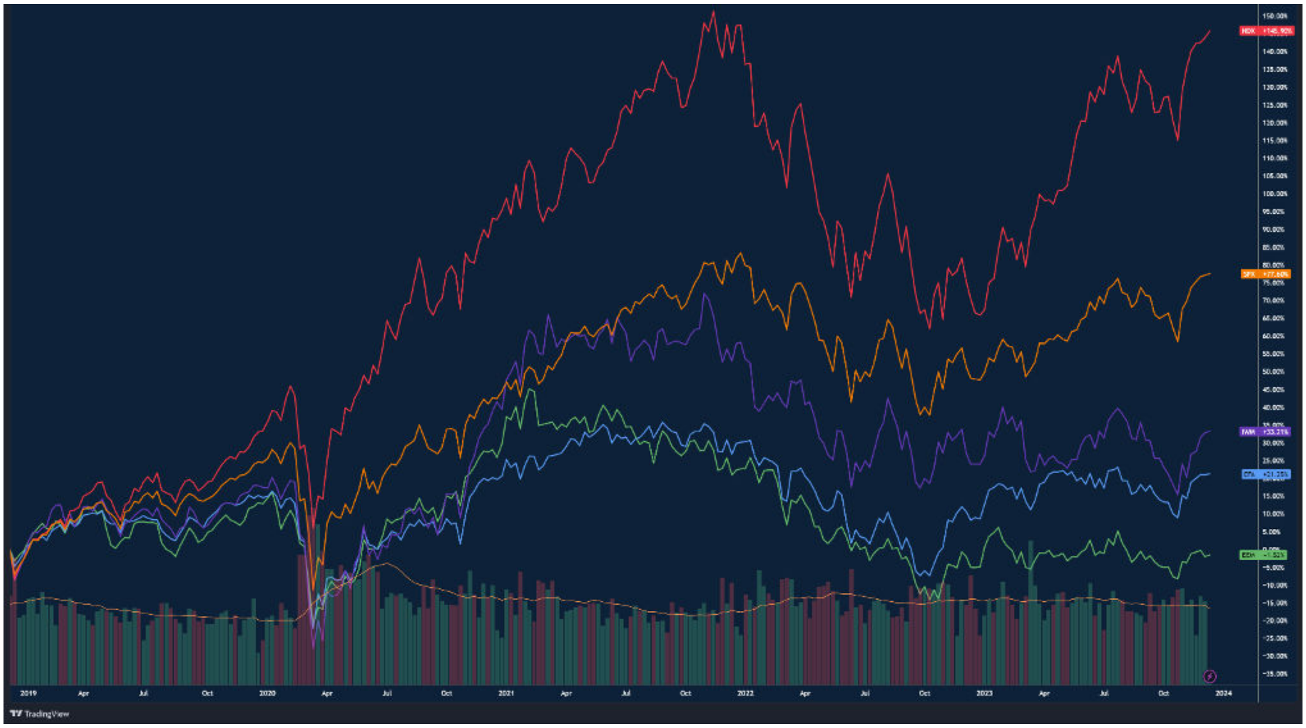
The question is: where has money flowed during this bond market route? That's right – companies such as Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla & Facebook, famously nicknamed the "Magnificent Seven" because they throw off predictable, massive free cash flows and are buying back gobs of stock annually. These have been the *de facto* safe-haven assets. They have also been a direct beneficiary of the reckless (in our opinion) government/monetary policy we have seen at the expense of smaller and more indebted companies who don't have the balance sheets to weather any storm on the horizon. Not to mention the boon of artificial intelligence that seemed to come out of nowhere and hit the earth like an asteroid. Investors, as we've seen demonstrated time and time again, have bid these companies up and placed a large liquidity, quality, and even monetary premium to store wealth in the Mag-7 stocks due to the sheer amount of pricing power and stability they've attained. We think these companies are fascinating in how they've been able to trample competition throughout the years, but we're also cautious with how fast technology is moving out on the spectrum. The clearest example being ChatGPT which is only slightly older than one year and managed to attain a $100 billion valuation with over 180 million users globally.



Data Analysis of World of Statistics

Over the course of the next decade, we believe technology, specifically AI, machine learning and automation, will provide much-needed boost to global productivity and continue to disrupt traditional business models. When one looks outside of the Magnificent 7 companies, there are many businesses that are capitalizing on these trends today and building for the growth coming. We are even starting to see new technological solutions gain momentum that aim to disrupt the very way we store, preserve, and self-custodially transmit liquid value across borders. Bitcoin is only 15 years old and has proven its resiliency amidst a constant backlash from skeptics, seeing its network grow at a very rapid pace that has even outpaced early internet adoption so far in its short history. There is a lot to be excited about in the coming years as the world goes through digital transformation in perhaps ways we haven't seen before.

To illustrate the dominance of large-cap tech vs. other economically sensitive areas of the market, see below in red (tech-heavy Nasdaq that has 50% in the Magnificent 7 stocks) over the last 5 years against all other major indices: S&P 500 (orange), small cap index (purple), international index (blue) & emerging markets (green).



In turn, at CenterPoint we have put much thought and consideration into how to structure client portfolios in such a challenging and fast-paced digitally first world. We still think diversification can reap benefits to an overall balanced portfolio, but not in the famous and traditional 60/40 portfolio of 60% stocks, 40% bonds as we have been outspoken about many times. Why? Because putting 40% of your account into a diversified bucket of bonds worked beautifully when interest rates were falling from their secular peak in the 80's of 18% on the 10-year benchmark treasury. In a period of potentially higher and more volatile inflation and interest rates, there are likely better opportunities in other areas to preserve purchasing power to meet your goals. As the legendary investor Bill Miller has mentioned many times: "In the post-war period the US stock market has gone up around 70% of the years because the US economy is growing most of the time. Those are way better than casino odds! People tend to try and guess the other 30% of the time when markets will go down." The markets always have and always will climb multiple walls of "worry" each month, that is simply a feature of investing in the stock market. As always, it is our pleasure to continue working with each one of you. Please don't hesitate to reach out to us with any updates or questions/concerns.

Sincerely,

Dan Grant Jordan

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