claret Asset Management

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The bumpy road to equilibrium...

October, 2022

The push and pull of inflation and interest rates, full employment and millions of jobs unfilled, unchecked demand and broken supply chains, exuberant investors, and shameless hucksters – all make for a wild ride as the Fed tries to pull on the reins of a frothy economy by taking away the punch bowl of free money. Inflation finally slows the endless desire to consume and the reality of the economic imbalances bites.

Let's start with interest rates...

As we mentioned in our last quarterly letter, higher interest rates will eventually act as a brake to this economy on steroids that is mainly funded through extreme fiscal largesse and printed money by central banks. Since then:

- First signs of a slowdown have been announced by FedEx in September 2022, calling for significantly lower profit and revenue for the year and signalling that 2023 will be worse.
- Then the semiconductor manufacturers announced a glut in inventories and are taking steps to cut production and scale back on plans to build out capacity to bring supply back in line with sinking demand..., this after the mad chase for chips in 2021 and 2022...
- Used car retailer CarMax announced declining sales (in units) for the quarter, citing low consumer confidence. Moreover, loan loss provisions more than doubled, signalling weakening consumer demand due to inflationary pressure and higher financing rates.

Yet, inflation is still higher than interest rates... not an incentive to save for most people. Either inflation must come down or interest rates have to go up further. Or both. And probably both.

One two punch of inflation and interest rates, a recipe for Bear markets...

Now that they are taking the punch bowl away and the party is over, what happens next?

For whatever reason, the stock market seems to always precede the economic reality:

- FedEx stock price is already down from a high of $319.90 reached on May 27th, 2021, to around $200 the day it announced the bad news. Since then, it went down another 25% to $150.

- Micron reached a high of $98.45 on January 5th, 2022 and is trading at $50.00 today*. Nvidia, the other semiconductor giant, reached a peak of $346.47 on November 22, 2021, and corrected 65% to trade at $121 today*.

- As for CarMax, the stock price has been cut by more than half, dropping from a high of $156 on November 8, 2021, to today's* $66.

- Poshmark, a social commerce marketplace, went public at US$42 in January 2022, started trading at over $100, and dove from the high to less than $10 in June 2022. The company just agreed to sell itself to the Korean company Naver for $17.90 or less than 43% than the price it was sold to the public 9 months ago. We have to presume it was the company's only chance for survival.

*As of September 30th, 2022

These are profitable companies (except for Poshmark). Imagine the ones that have been losing money for the last few years. In our last quarterly letter, we call them "Zombie" companies. These companies managed to go public by way of Initial Public Offerings (IPOs), raising capital with the help of investment bankers and their sales teams. Their business models are, at best, dubious but they tie up a lot of human capital and they have money to pay their employees -- shareholder's money.

These names come to mind: Lightspeed, Dialogue Health, GoodFood, Beyond Meat, Peloton just to name a few.

Until some of these names improve their business models, restructure, or disappear, this bear market still has some time to run.

We also mention that before the bear market is over, we could witness some sort of credit event. Credit Suisse could be one of them. It is almost unthinkable that a Swiss giant in finance can manage to destroy itself through speculative and dumb decisions/acquisitions made by incompetent management throughout the 90s and the 2000s. Shareholders paid a hefty price, having witnessed a

stock price of CHF 65 in 2007 diving toward today's CHF 4. Then again, anything can happen in finance, especially when stupidity is compounded by over**L**everage and il**L**iquidity, the same **L** squared we mentioned in the last letter.

As we are on the topic of financial institutions, we believe that the American and Canadian banks are very solid companies. Regulations have helped them strengthen their balance sheet since the Great Financial Crisis of 2008-2009. If there is a weak spot in the financial system today, it would be in "Shadow Banking", i.e., the unregulated financial institutions in the system. In a convoluted way, our banks do partly finance these unregulated entities through corporate loans and bond investments. That would include all types of lenders from the "loan Sharks", "Buy Now Pay Later" to "crypto lending" etc.

As this bear market progresses, we can only think about what Buffett said in one of his letters: "**it is only when the tide is out that we know who is swimming naked**". Many of you have asked the question: **Why not sell, stay on the sideline, and get back in when it is opportune?**

Alas, we wish we were that good at timing the ins and outs... and able to avoid the friction of taxes, trading spreads and commissions, etc., especially the capital gain taxes accumulated over the good years...

We are convinced that compounding is the magic in accumulating wealth, especially compounding with other people's money. Simplistically, every winning position in your portfolio has accumulated a liability that is called capital gain tax (and in the case of an RRSP, a deferred income tax). However, the government only collects when you sell it (or withdraw funds in the case of RRSP).

Otherwise, it is like a loan to you, interest free and as long as you want (i.e., as long as you don't sell your position, the loan works for you free of charge). Thus, the longer you keep a good investment, the more compounding benefits come to you through this interest-free loan from the government. This is the main reason why money compounds much faster inside an RRSP than outside. This is also the reason for having a TFSA.

On Ukraine and Russia...

We have a tough time seeing a way out if Putin stays in power... it will be a long, protracted and painful process...

On energy transition and consumption...

Here are a few thought-provoking anecdotes:

- According to Bloomberg research, over USD $3 trillion have been invested in renewable energy in the last 10 years. Yet, today's energy consumption is still 80% supplied by fossil fuels, little changed from 10 years ago...
- And had we invested USD $3 trillion in research for better ways to contain nuclear waste, would we have found a more efficient way to renewables?
- While most companies have a "plan" to reduce fossil fuel use, and many countries see Carbon "0" as a reality within 30 years, there is little that shows us how these targets and goals can be realistically achieved. The costs are not being measured credibly.
- While extreme weather is a reality, what will all Electric Vehicle drivers do if they must evacuate, and the power grid is down? Are we supposed to have 2 cars? Or a spare battery for the car battery? What would replace the 10-gallon red gas can?

We certainly do not have answers to these existential questions. What we can do at Claret is try our best to manage your savings prudently and responsibly and provide you a reasonable return over time, by investing in companies with real business models that are well run, have great prospects and that generate positive cash flows for the foreseeable future.

Thank you for your confidence.

Alain Chung, Chief Investment Officer, on behalf of the Claret Team