CRESCAT CAPITAL®
THE VALUE OF GLOBAL MACRO INVESTING

MACRO PRESENTATION

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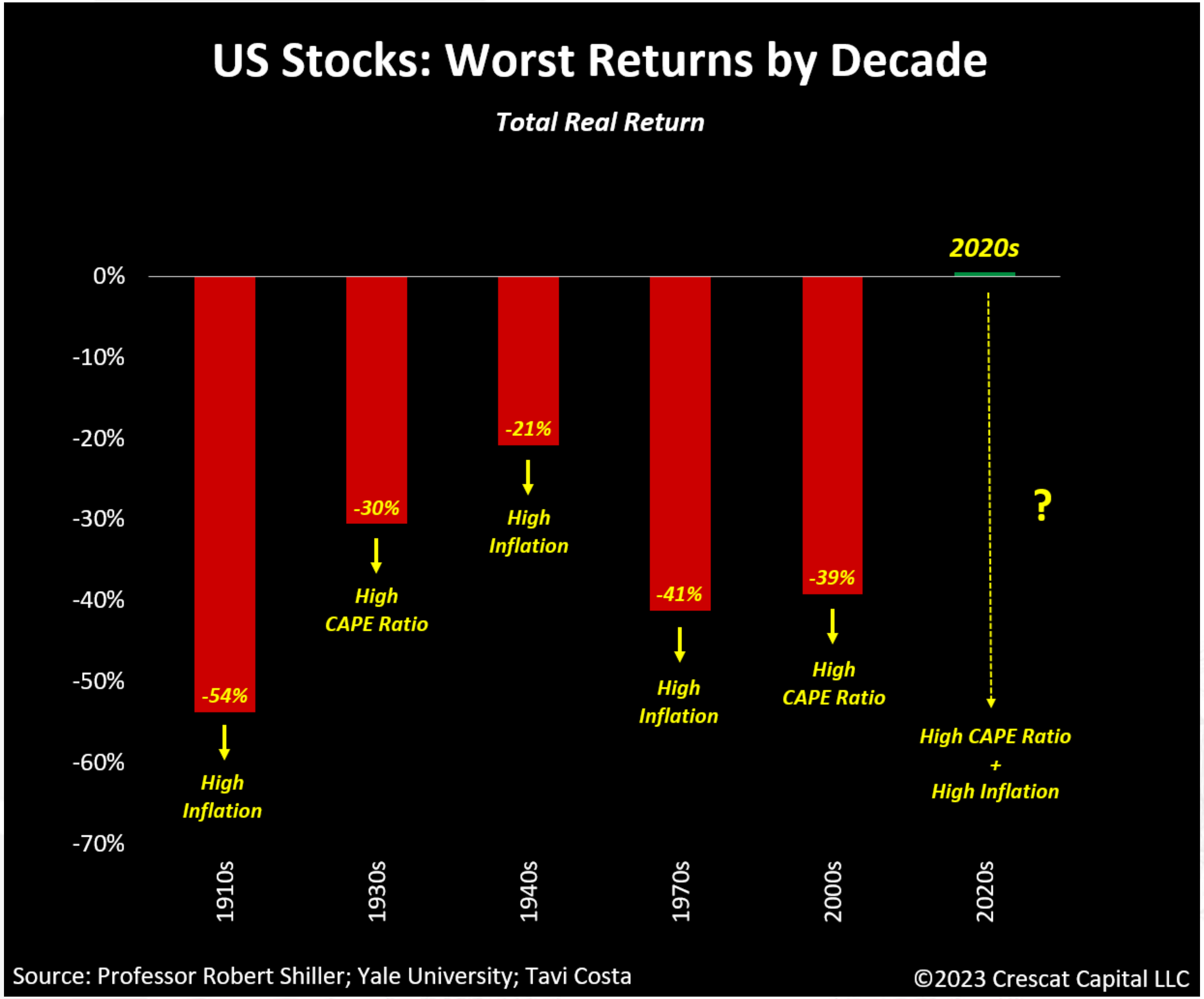
Today’s Structural Drivers of Inflation

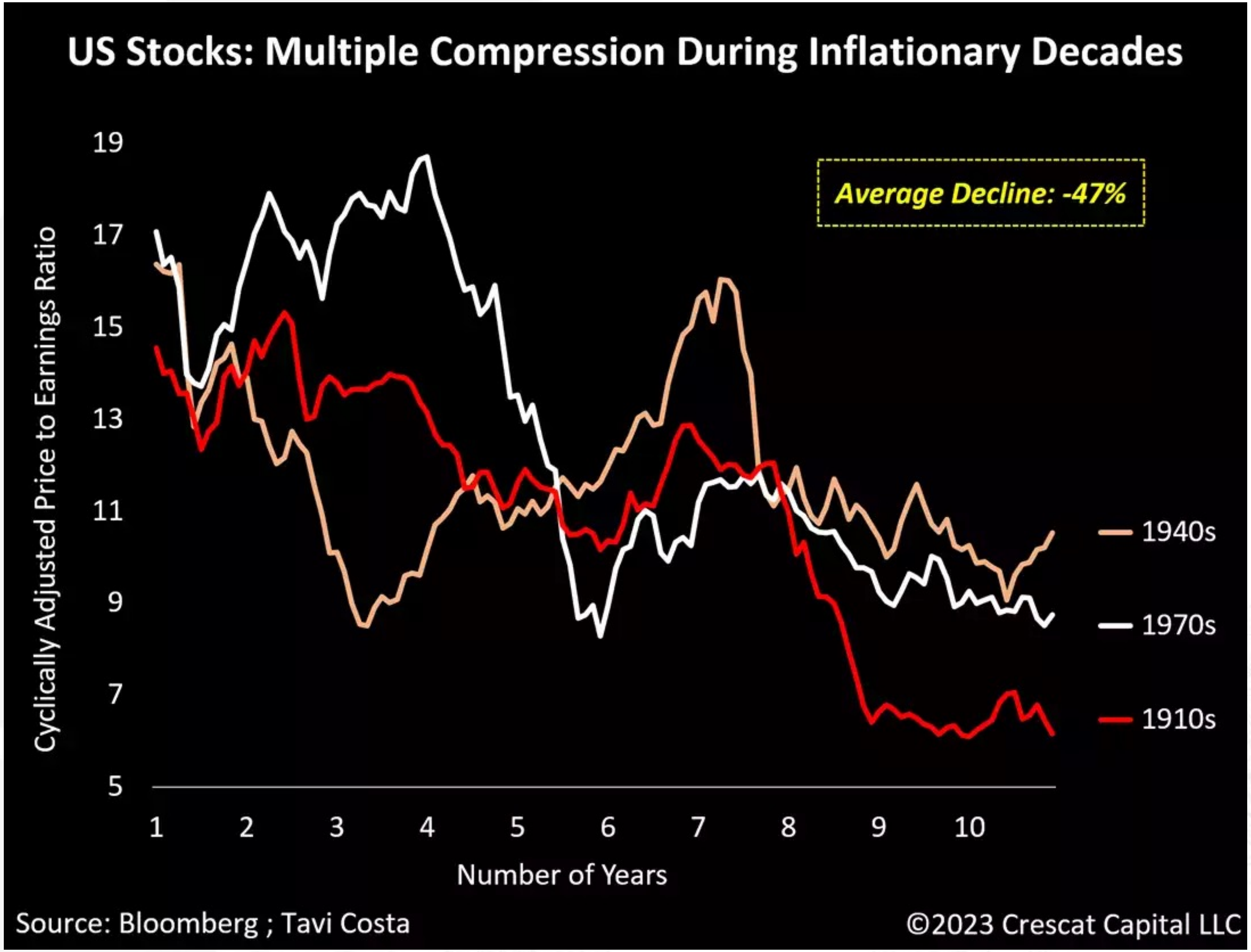
- **Demand-pull:** Manufacturing Revitalization
- **Cost-push:** Resource Underinvestment
- **Built-in:** Resurgence of Labor’s Pricing Power
- **Monetary:** Long and Variable Lags
- **Import-led:** Deglobalization

We agree that an economic downturn is likely, but we think it could be more severe in terms of market impact due to the re-acceleration of inflationary pressures.

If we are right, general investor positioning is off.



Since 1900, there have been only five decades that the total real return for US stocks was negative. In fact, they were all deeply negative. Three of these periods happened during inflationary eras. The other two occurred at a time when valuations of US equity markets were at historical levels. Today, we have both setups at the same time.

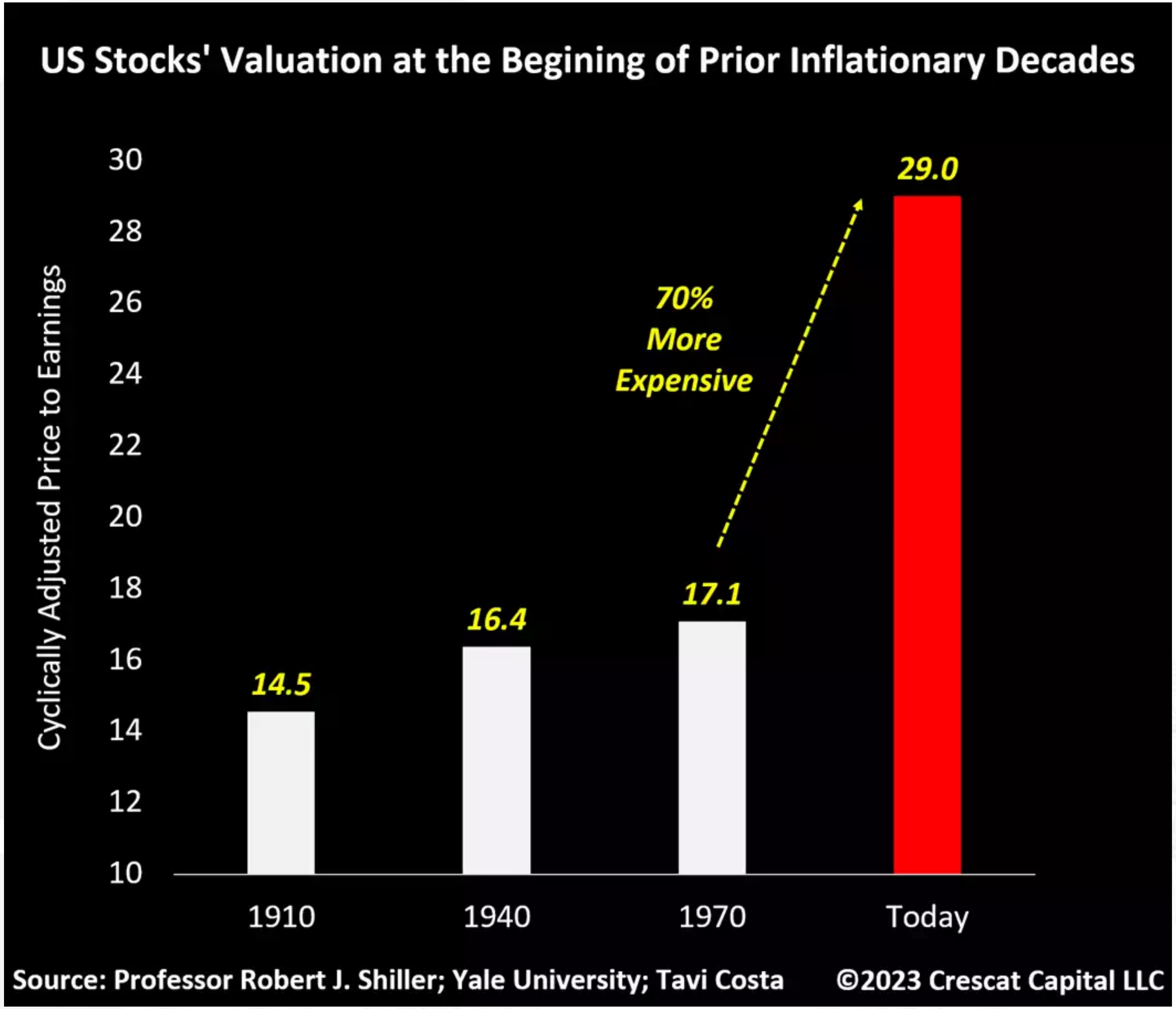


The last time we had a long period of higher-than-average cost of capital was in the 1910s, 1940s, and 1970s.

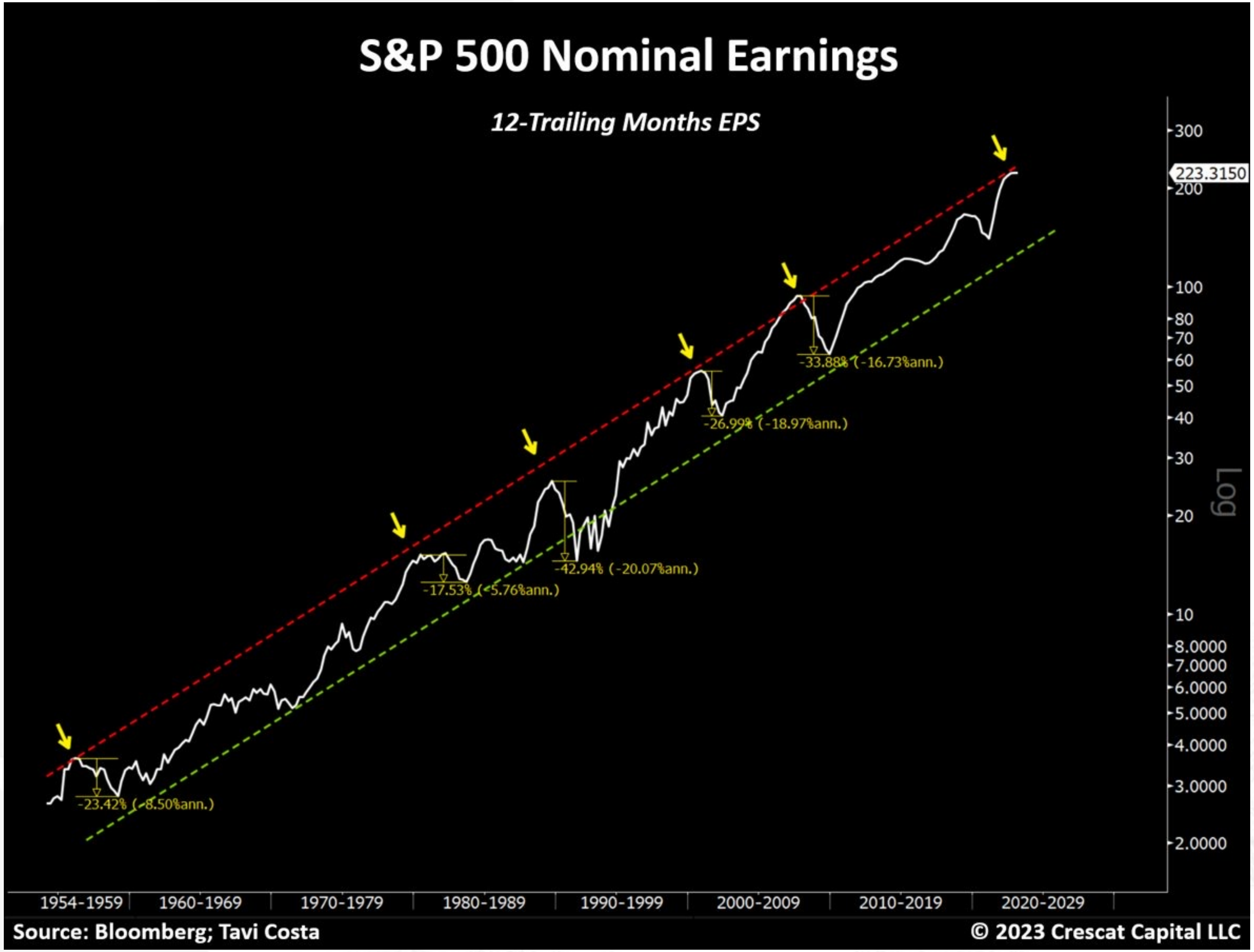
While each had its own unique circumstances, fundamental multiples for stocks significantly contracted over all those decades.

The average decline was nearly 50%.

More importantly, note that CAPE ratios shrunk to single digits at the end of two periods and to just 10.5x in the 1940s.

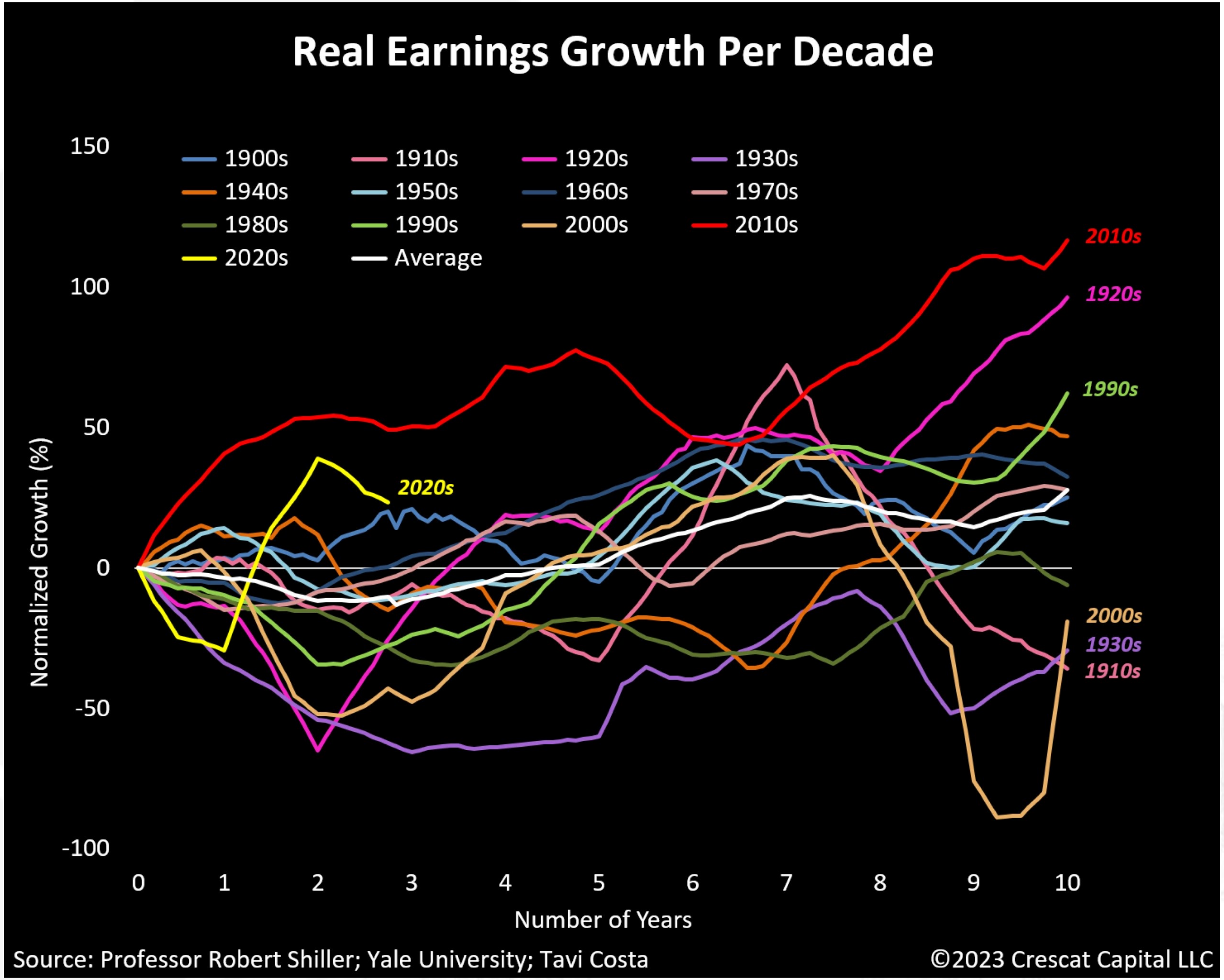


Today's valuations are over 70% more expensive than they were when each of those inflationary decades began.

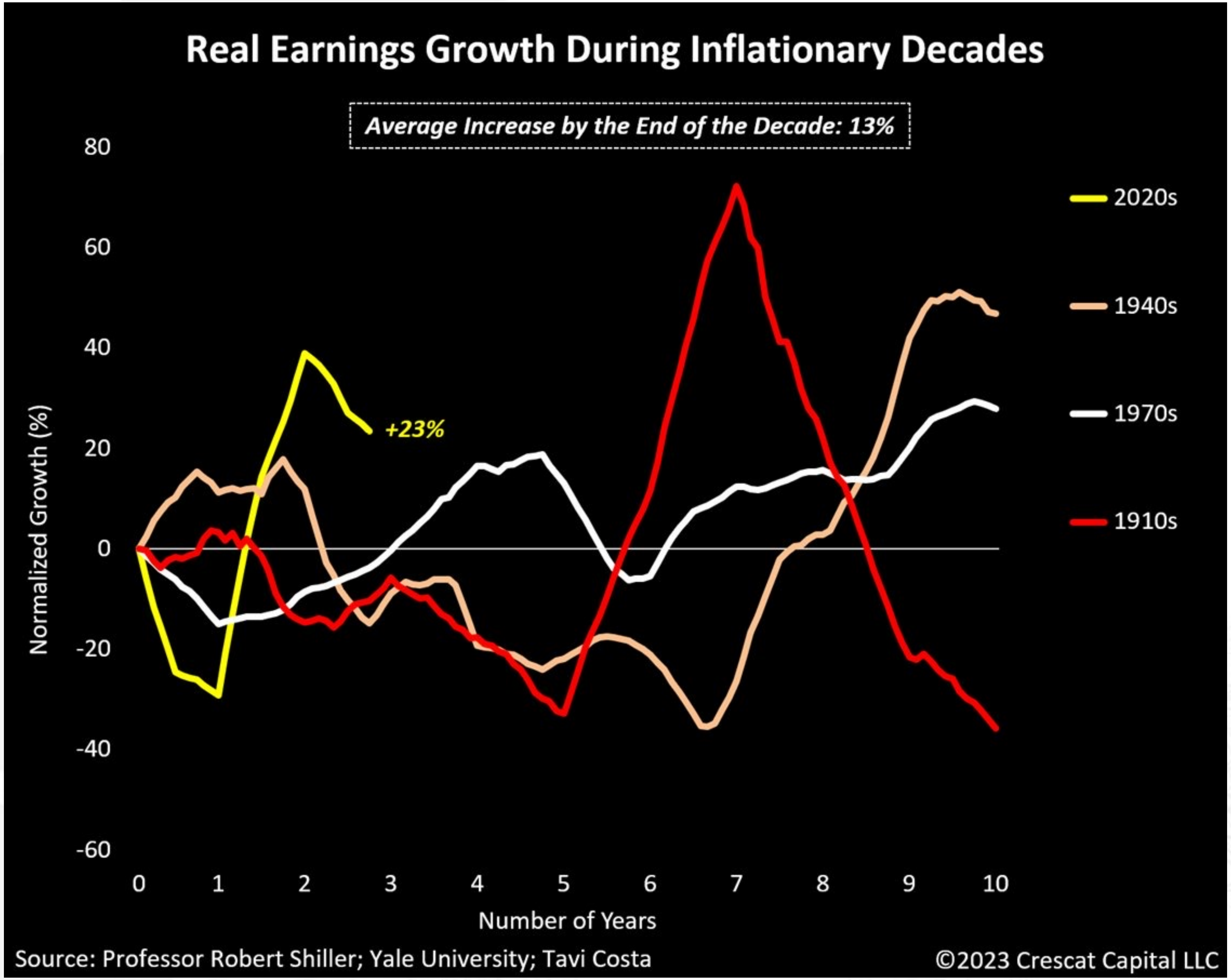


Every time profits reached the upper band of this range, an earnings recession followed.

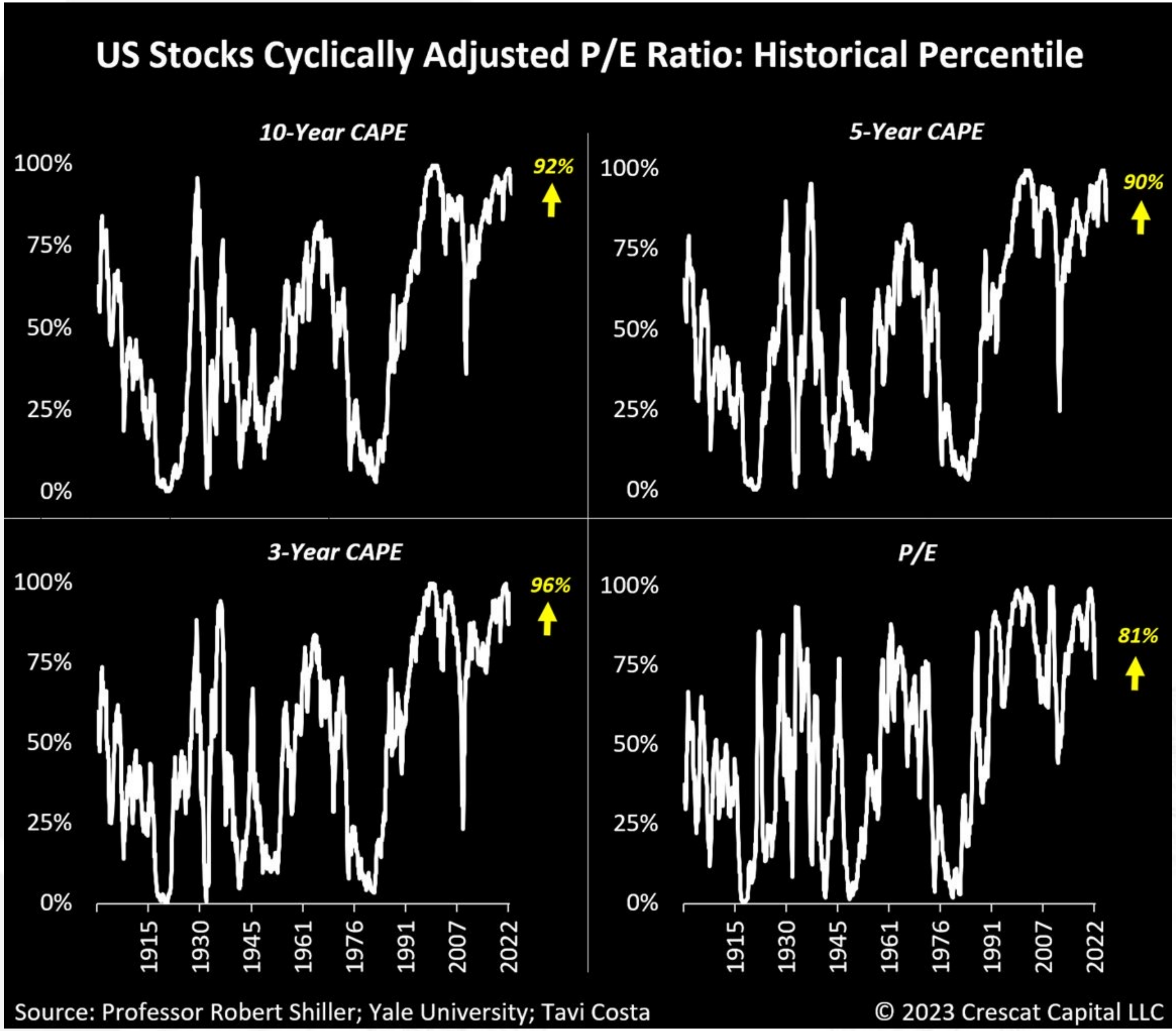
We are at a similar peak-level juncture again today while analysts continue to be overly optimistic.



When adjusting corporate fundamentals to inflation levels, the current real growth in earnings for this decade is on pace for being the second largest in history, which is right behind the prior decade's performance.
Note that outside of the 2010s, the other two times we had outstanding long-term increases in profits were in the 1920s and the 1990s.
Both periods preceded severe earnings recessions.

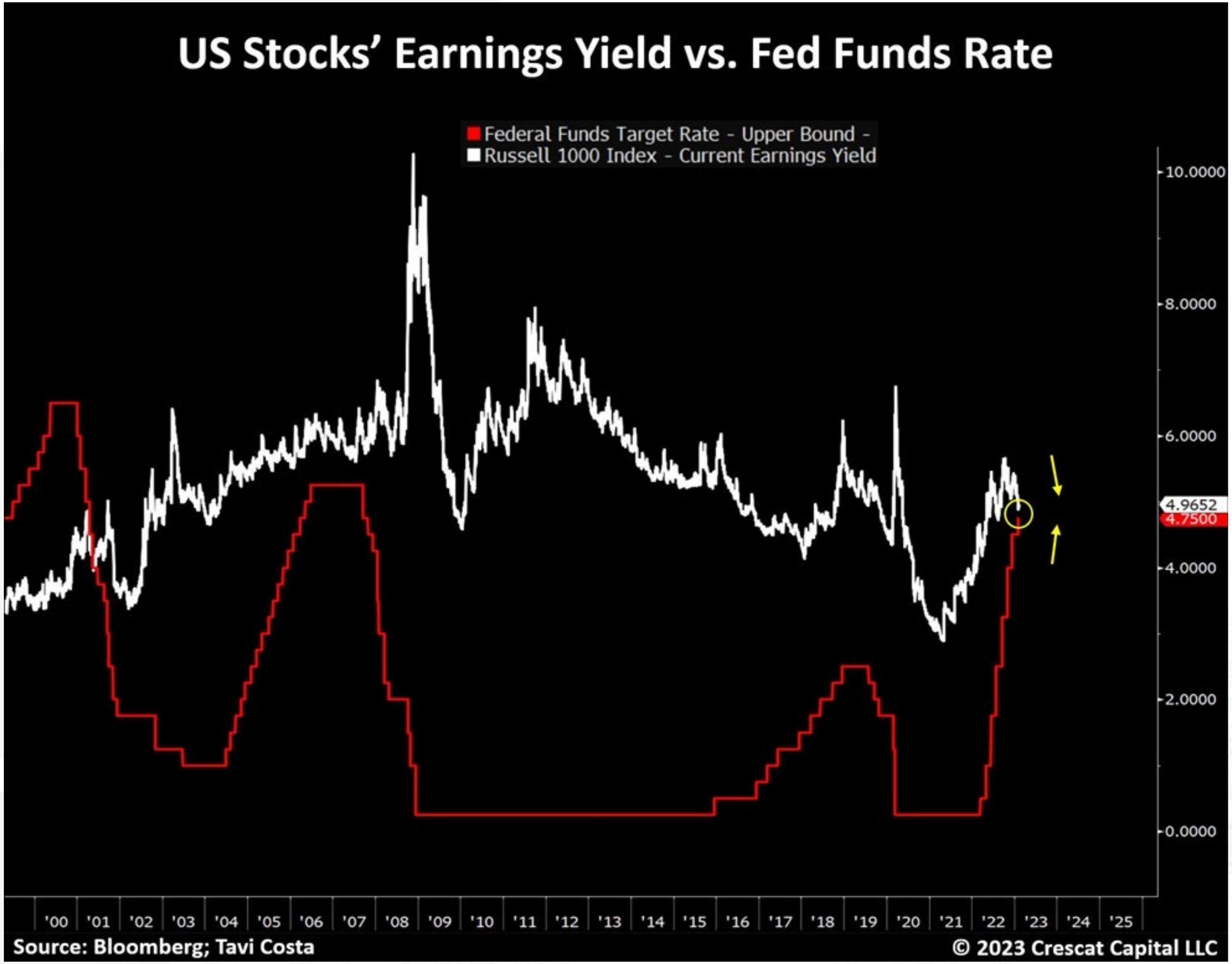


The issue today is that we are two years into the decade where real corporate earnings have already grown by 23% with companies achieving their highest profit margins in history, the lagged product of unprecedented monetary stimulus that has been reversed.

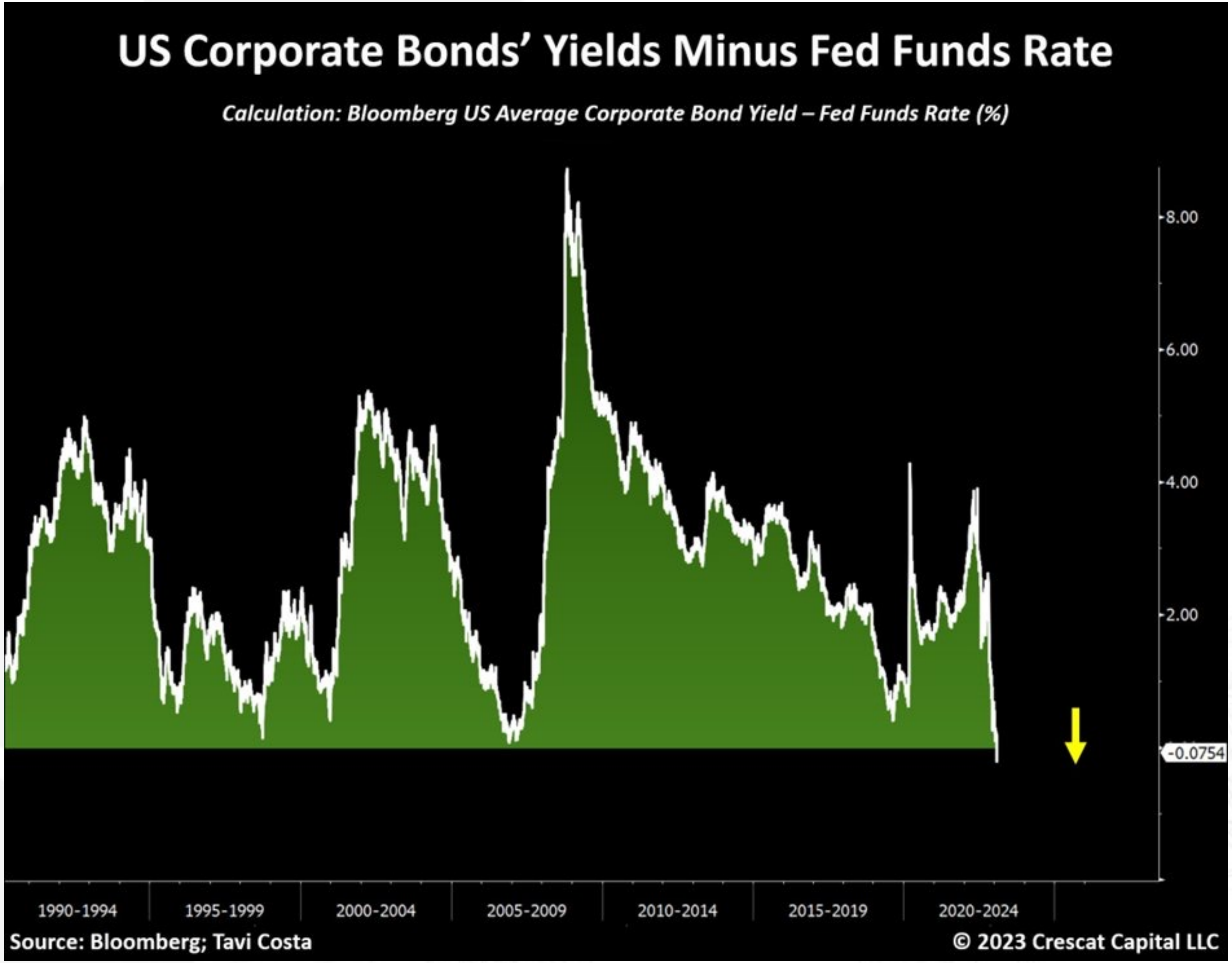


On a CAPE ratio basis, for instance, market prices are near record levels relative to 1, 3, 5, and 10-year cyclically adjusted earnings.

The only plausible way to justify the current multiples in equity markets would be if, for the first time in history, we were to experience a 50% increase in real earnings for back-to-back decades.



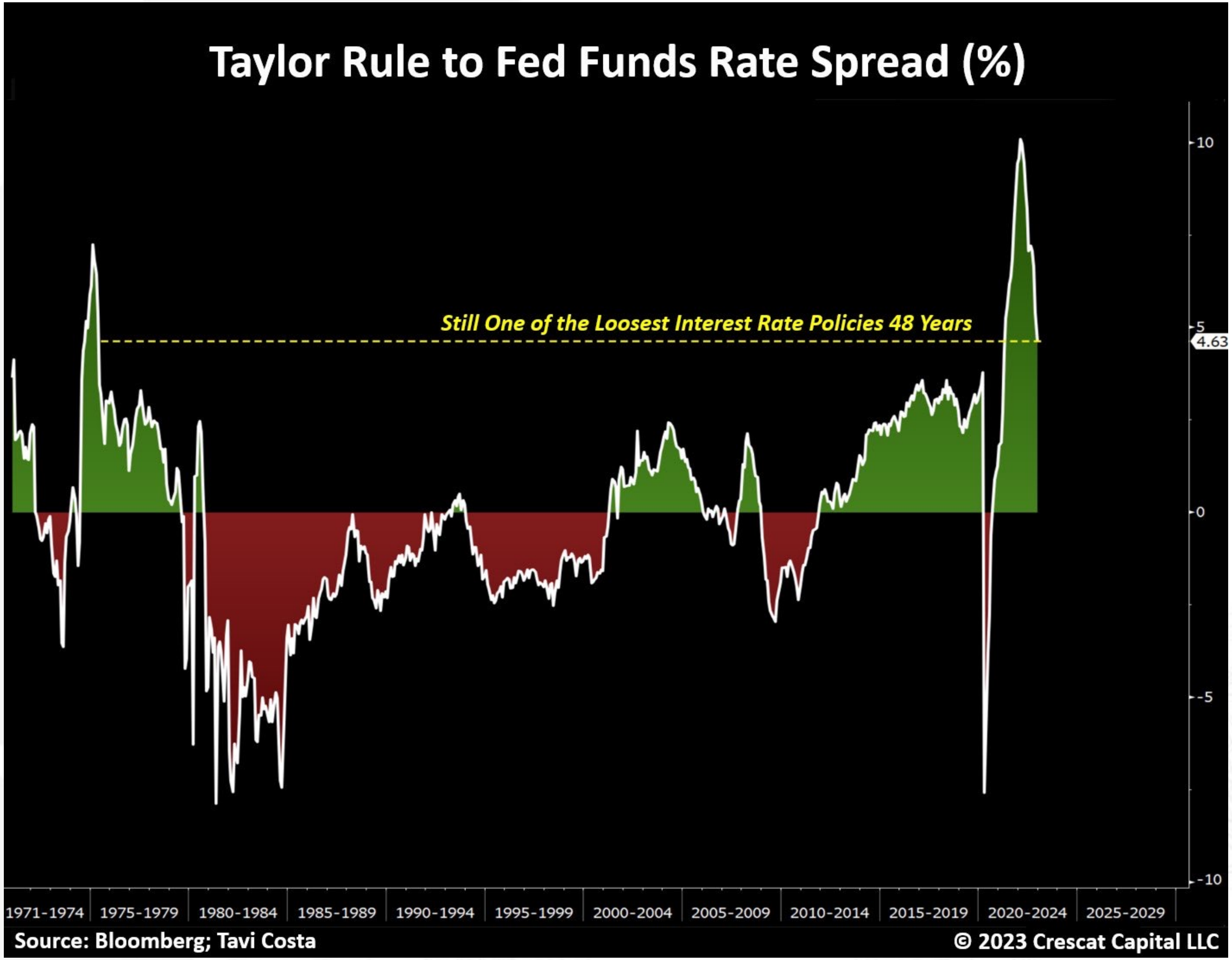
Earnings yield for US stocks is now close to turning negative versus the Fed funds rate for the first time since the tech bust.



Why would anyone take the extra risk of owning corporate bonds when one can receive over 4.75% yield risk-free?

This is arguably the most expensive part of today's market.

The US total equity market cap relative to its GDP has come down, but it is just re-testing the highs of the peak of the technology bubble in 2000.

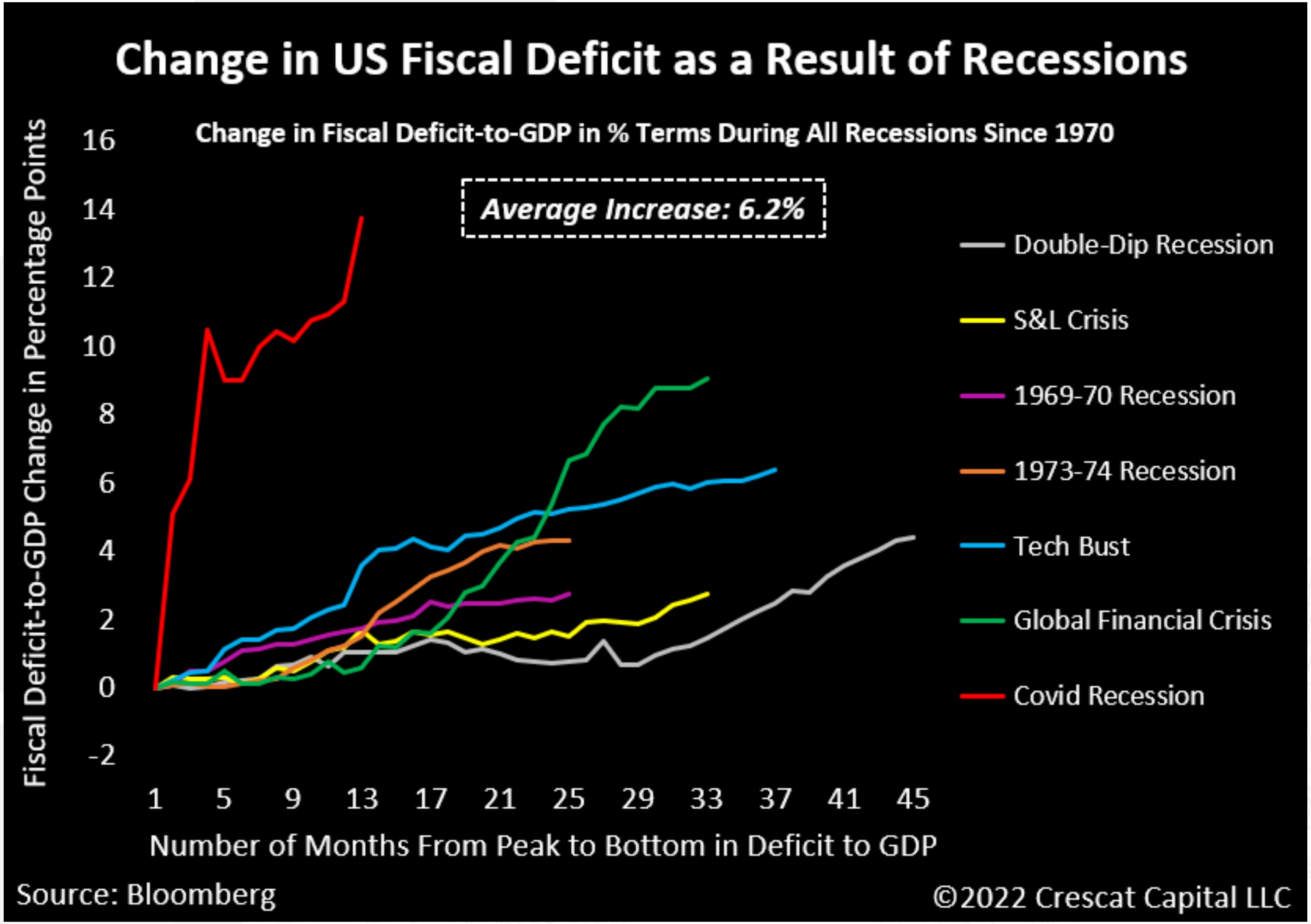


The Fed is playing with fire.

Despite the recent rate hikes, financial conditions remain way too loose.

This is typical of an early inflationary cycle.

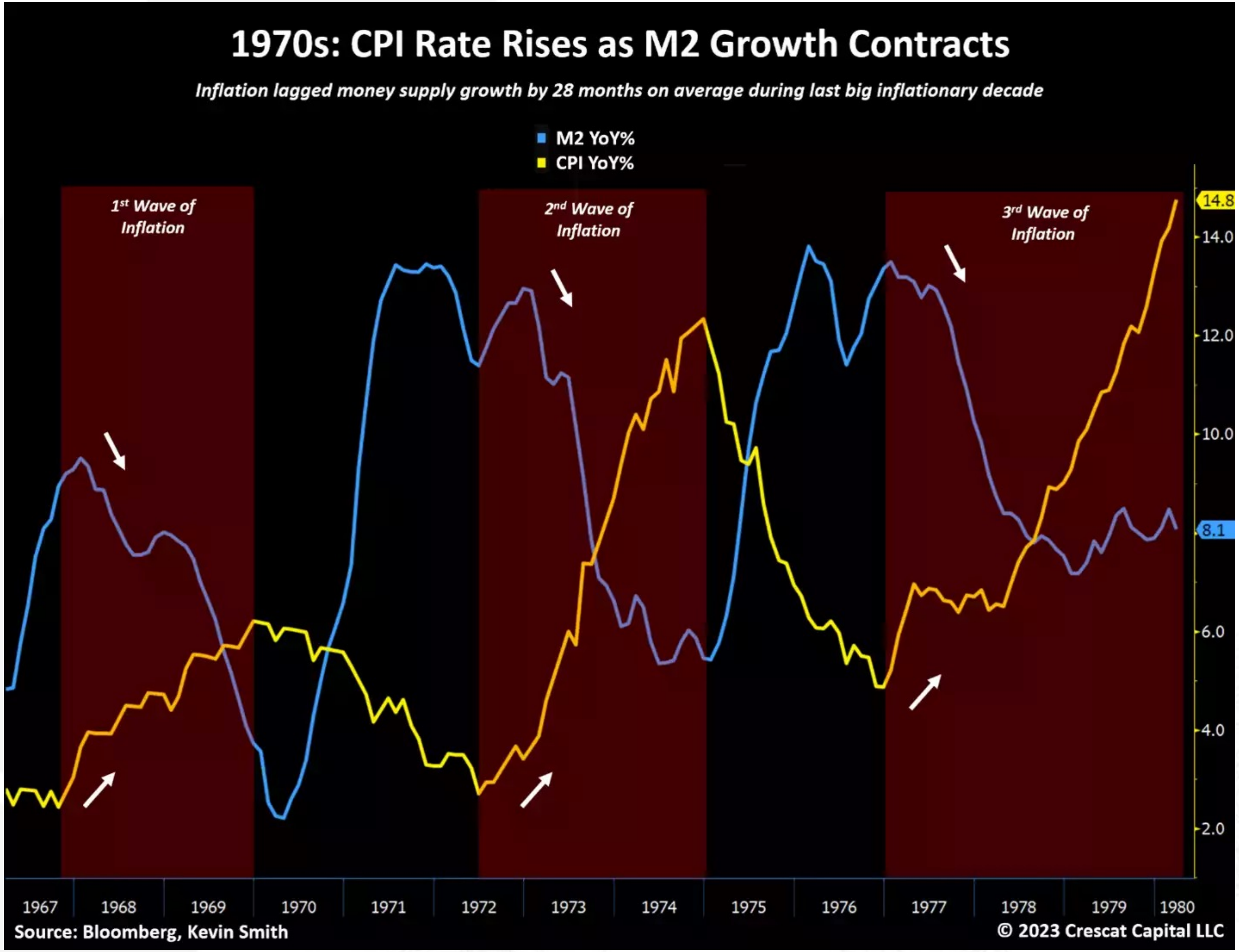
The longer inflationary forces persist, the harder will be to expel them from the system.



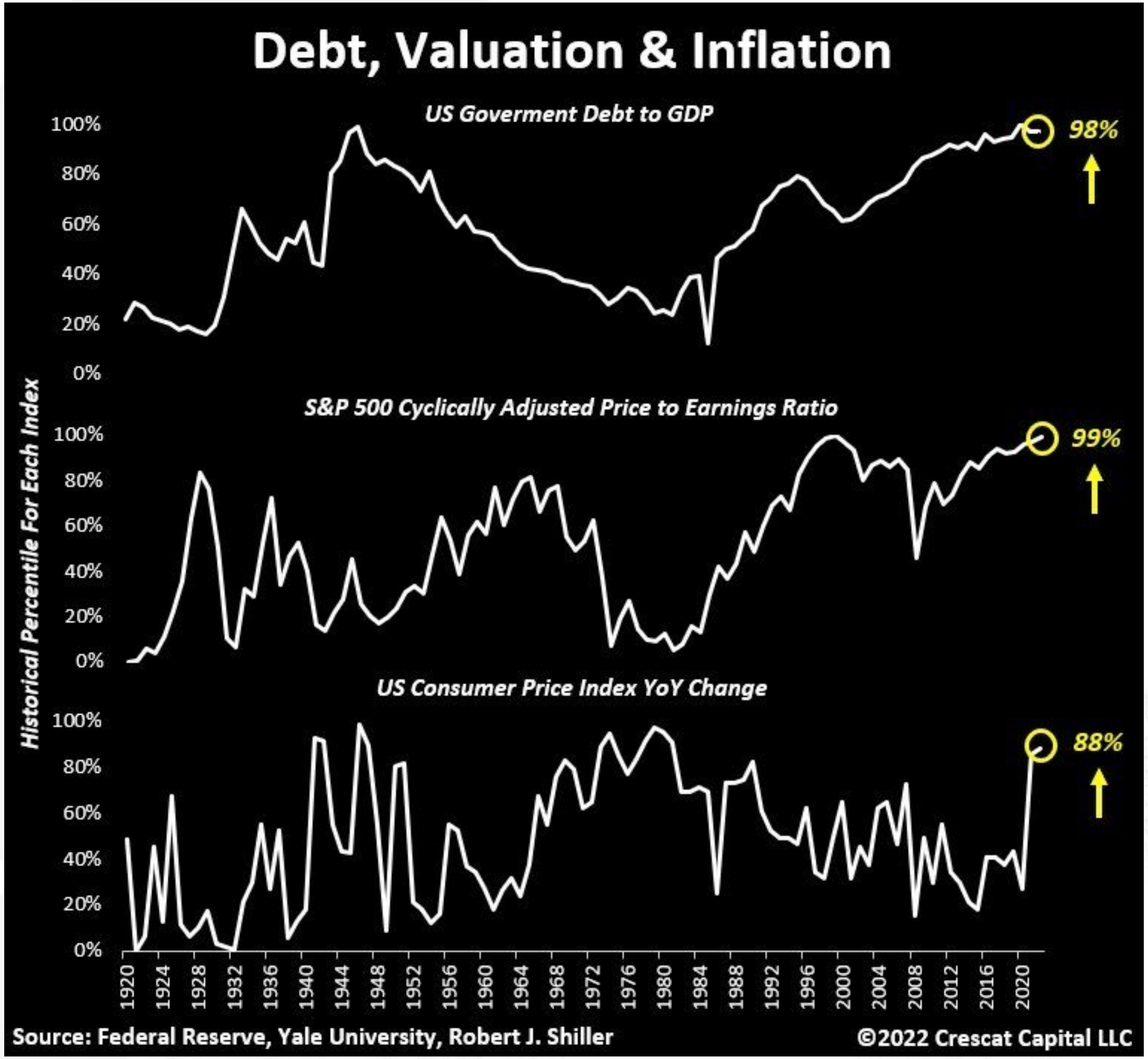
Looking at all recessions since 1970, fiscal deficit-to-GDP worsened by an average of 6.2%.

We think the next downturn will be no different.

However, government spending will likely be increasing with inflation rates already historically elevated so nominal GDP may also be rising.

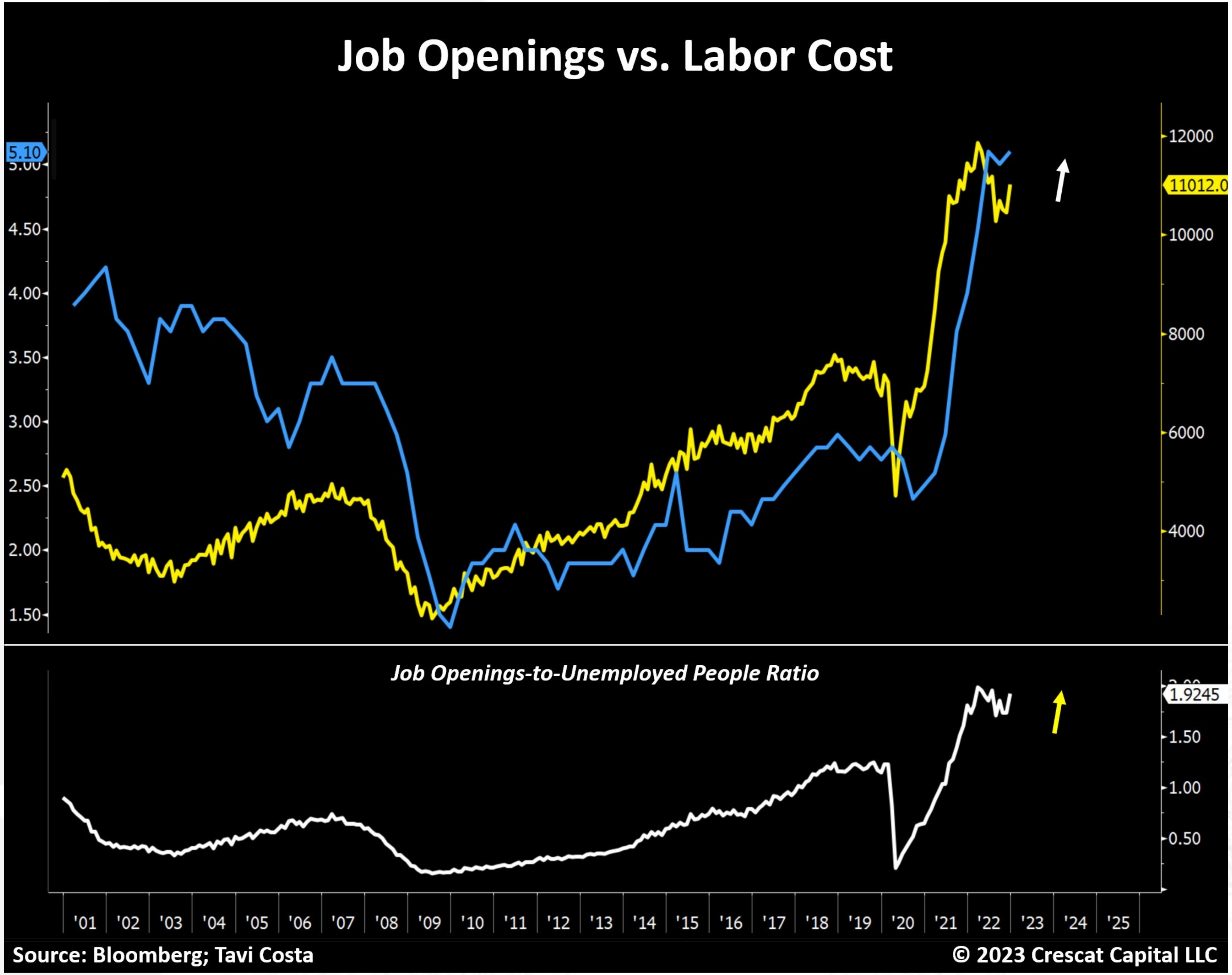


If Milton Friedman was correct that "Inflation is always and everywhere a monetary phenomenon", then there is a lot of missing inflation still destined to show up.



For the first time in history, the US is experiencing a confluence of three macro extremes all at once:

- High government debt to GDP like the post-war 1940s
- Excessive stock market valuation on par with 1929 & 2000 bubbles
- A resource-driven inflationary crisis environment comparable to the 1970s

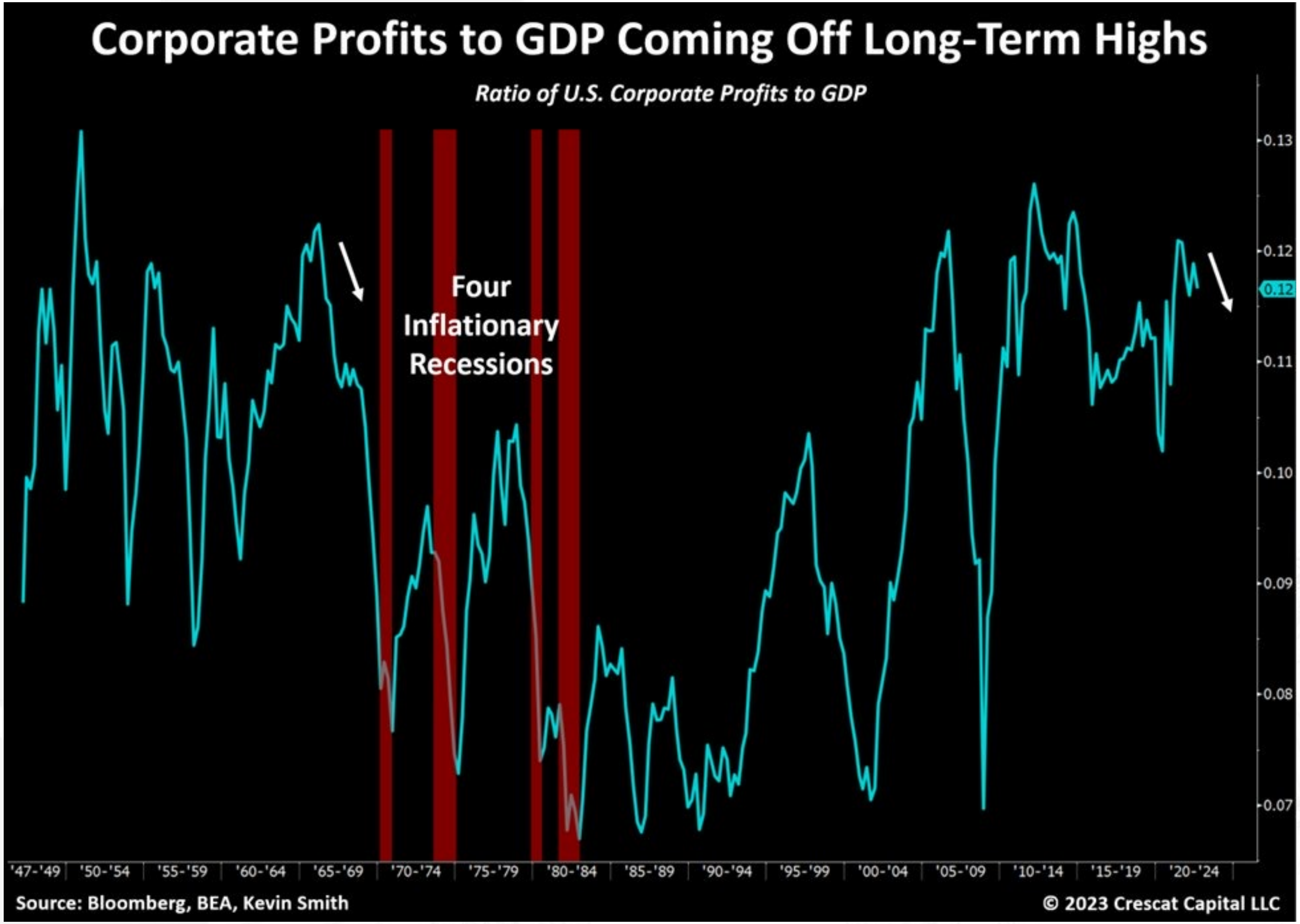


Growing deglobalization trends could severely add to this inflationary force, potentially marking the end of a cheap labor era. If these changes manifest themselves, corporate fundamentals could be at risk of severe deterioration.

The rising labor cost pressure is likely to become another secular inflationary driver.

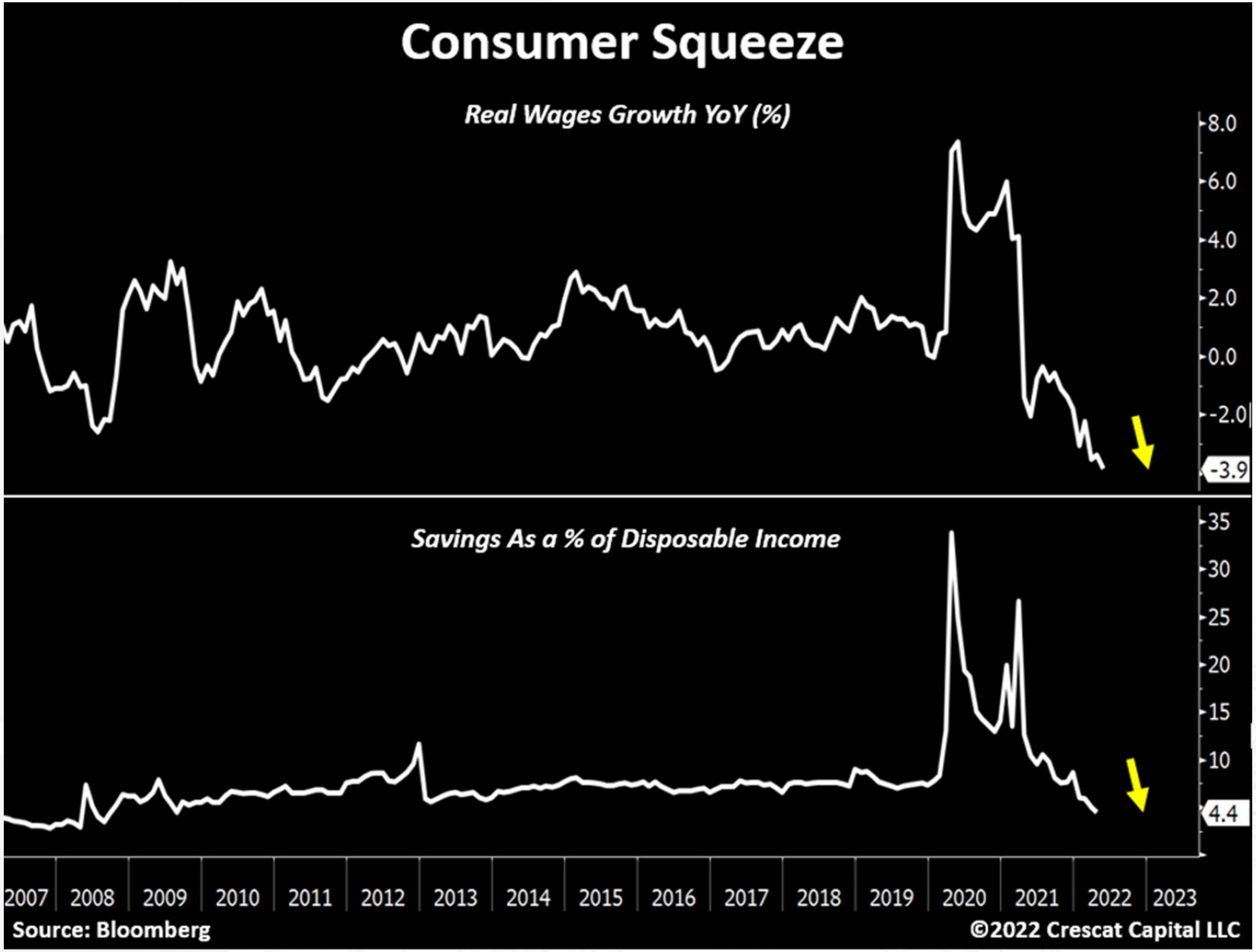
Today's loose monetary conditions by Taylor Rule standards are only exacerbating this macro force.

Workers' share of economic activity through wages and salaries is coming off historic lows as the workforce population growth is likely to remain constrained.



The share of GDP going to corporate profits is also coming off historic highs.

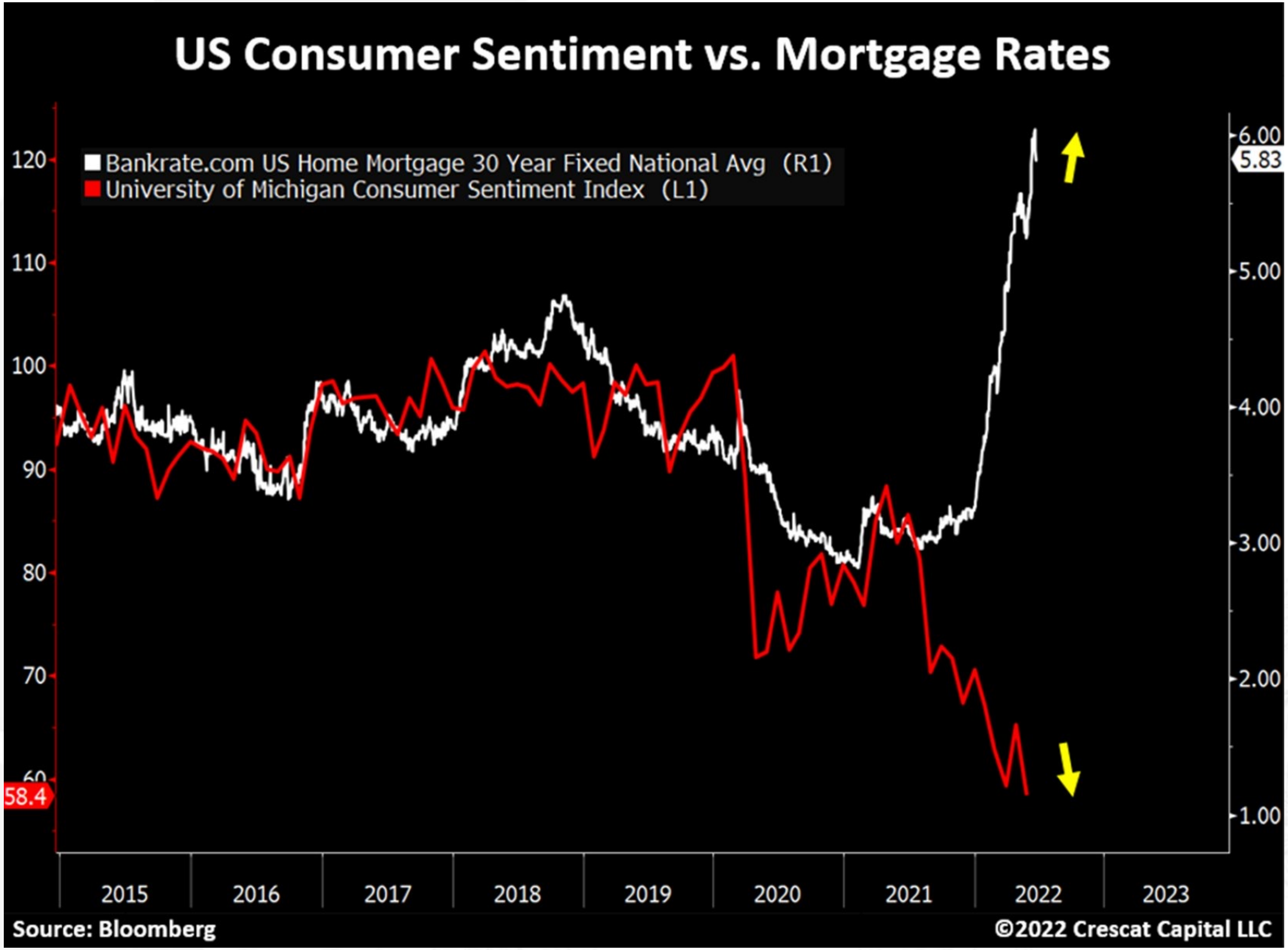
This is the mirror image of labor's increasing pricing power but also highlights the risk to corporate profits which can get squeezed in an impending inflationary recession like those of the 1970s.



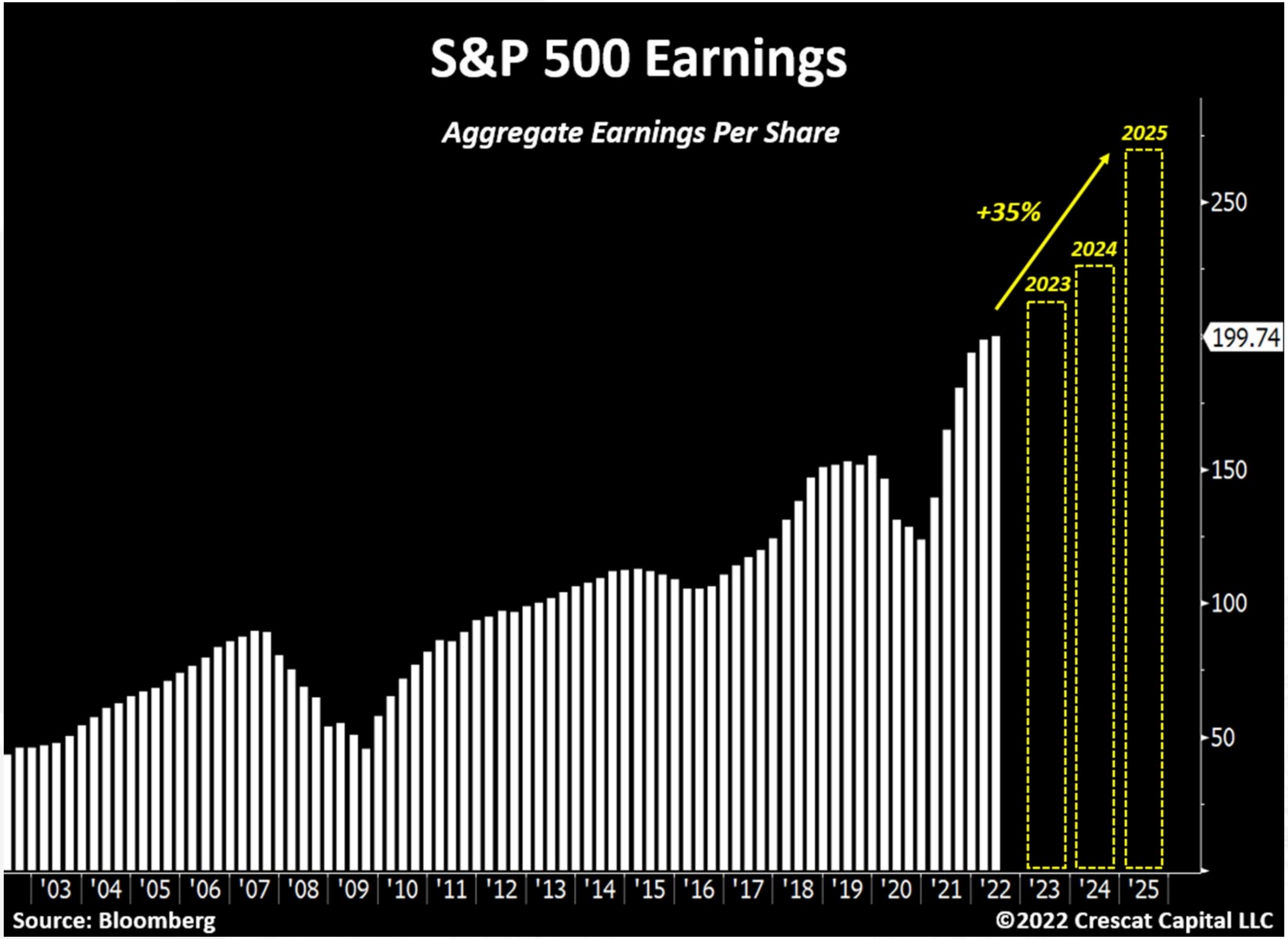
While workers are starting to make more money, the growth in salaries is not outpacing inflation. In real terms, wages are declining by almost 4%, worse than the Global Financial Crisis.

After a historic surge, saving rates are also plummeting.

Relative to disposable income, they are now at the lowest level in 14 years.

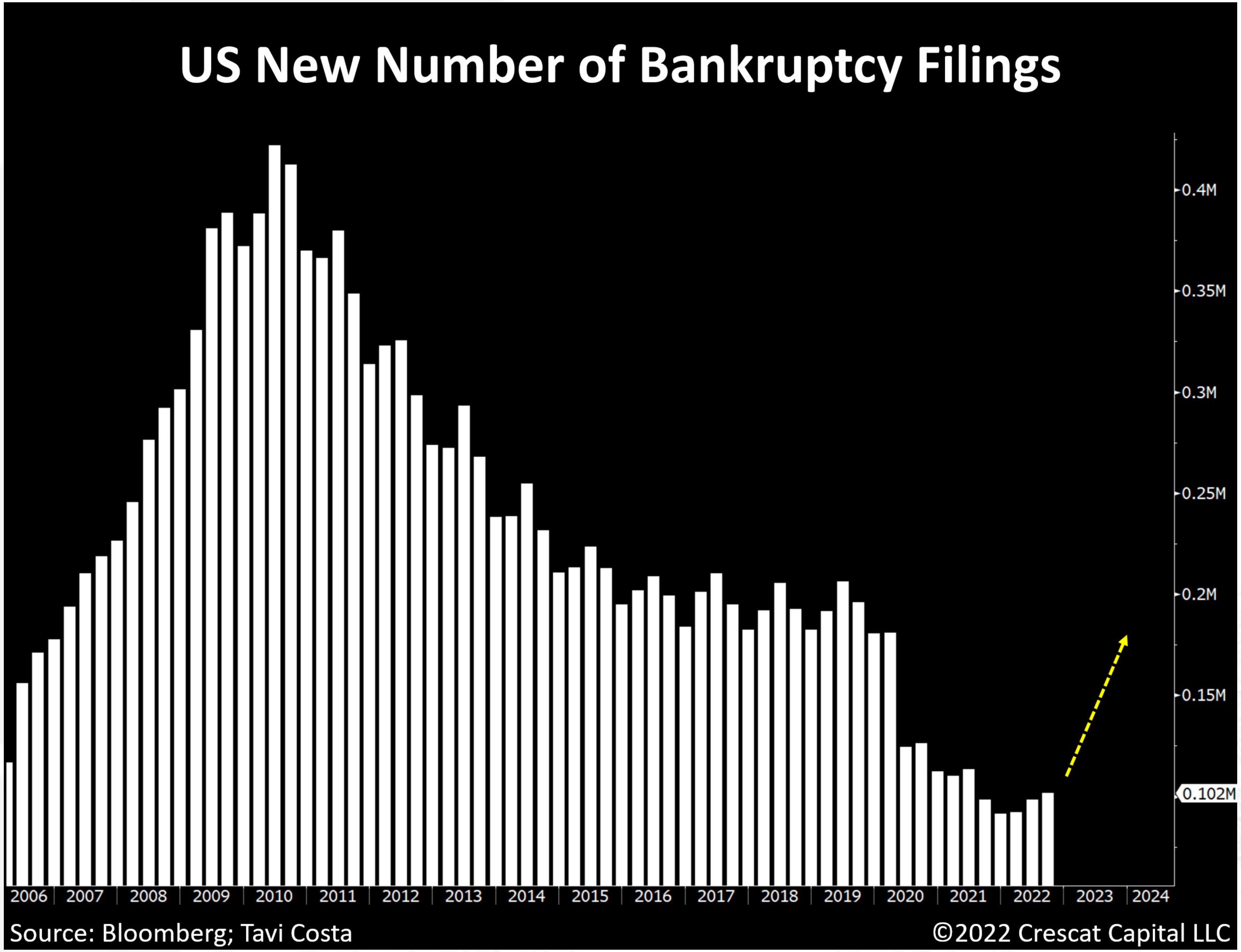


For those who believe consumer demand will remain strong after 30-year mortgage interest rates doubled in the last six months, we think it is time to reconsider that view.



As usual, Wall Street analysts are looking in the rear-view mirror.

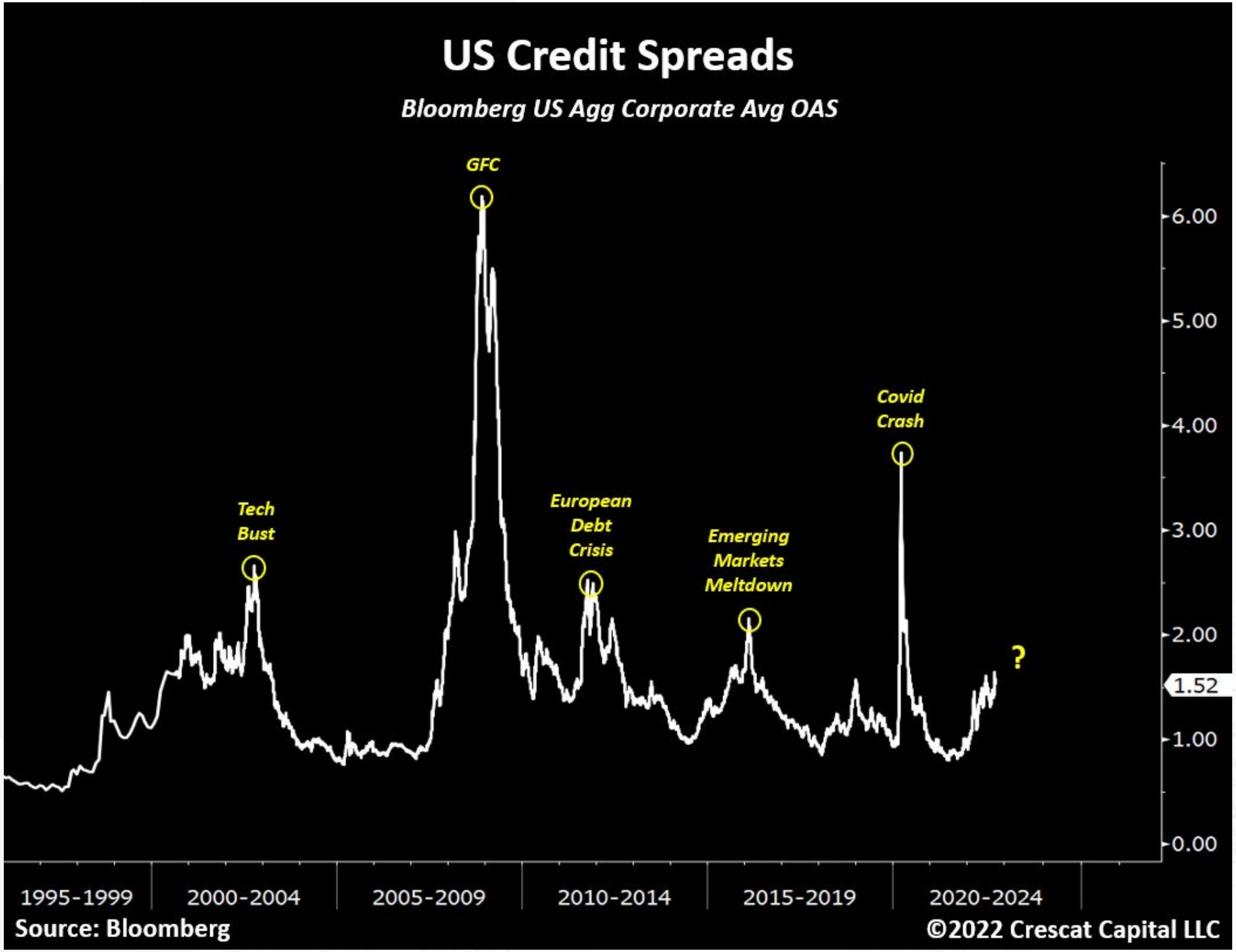
After a stimulus-led surge in corporate earnings to record levels, they are projecting another 35% spurt over the next 3 years giving little to no consideration to the monetary tightening and fiscal stimulus falloff.



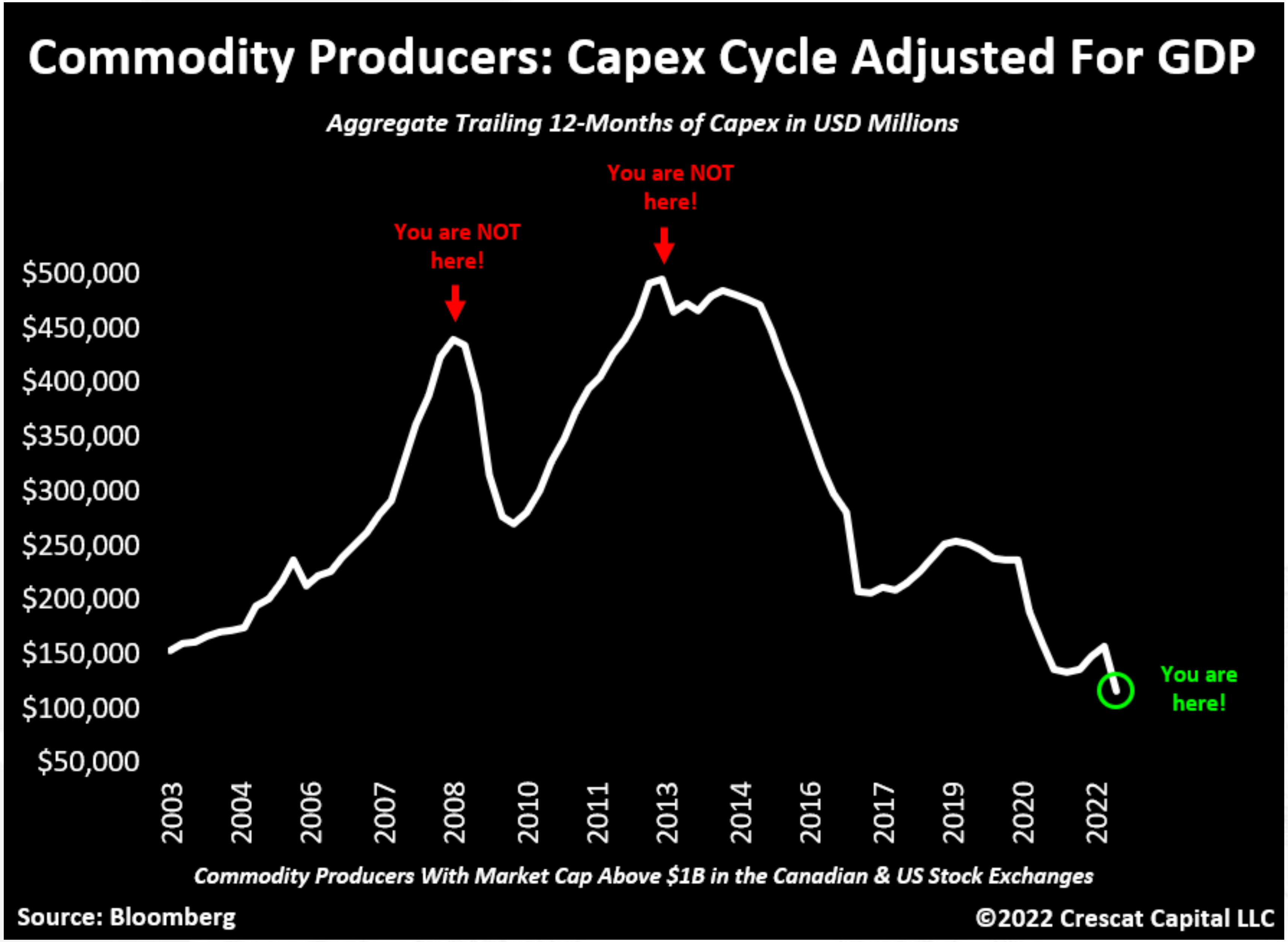
Prior to the GFC, the number of bankruptcies was rising exponentially.

Today, it remains at historically low levels.

The tightening of financial conditions worldwide is setting the stage for significant credit events ahead.

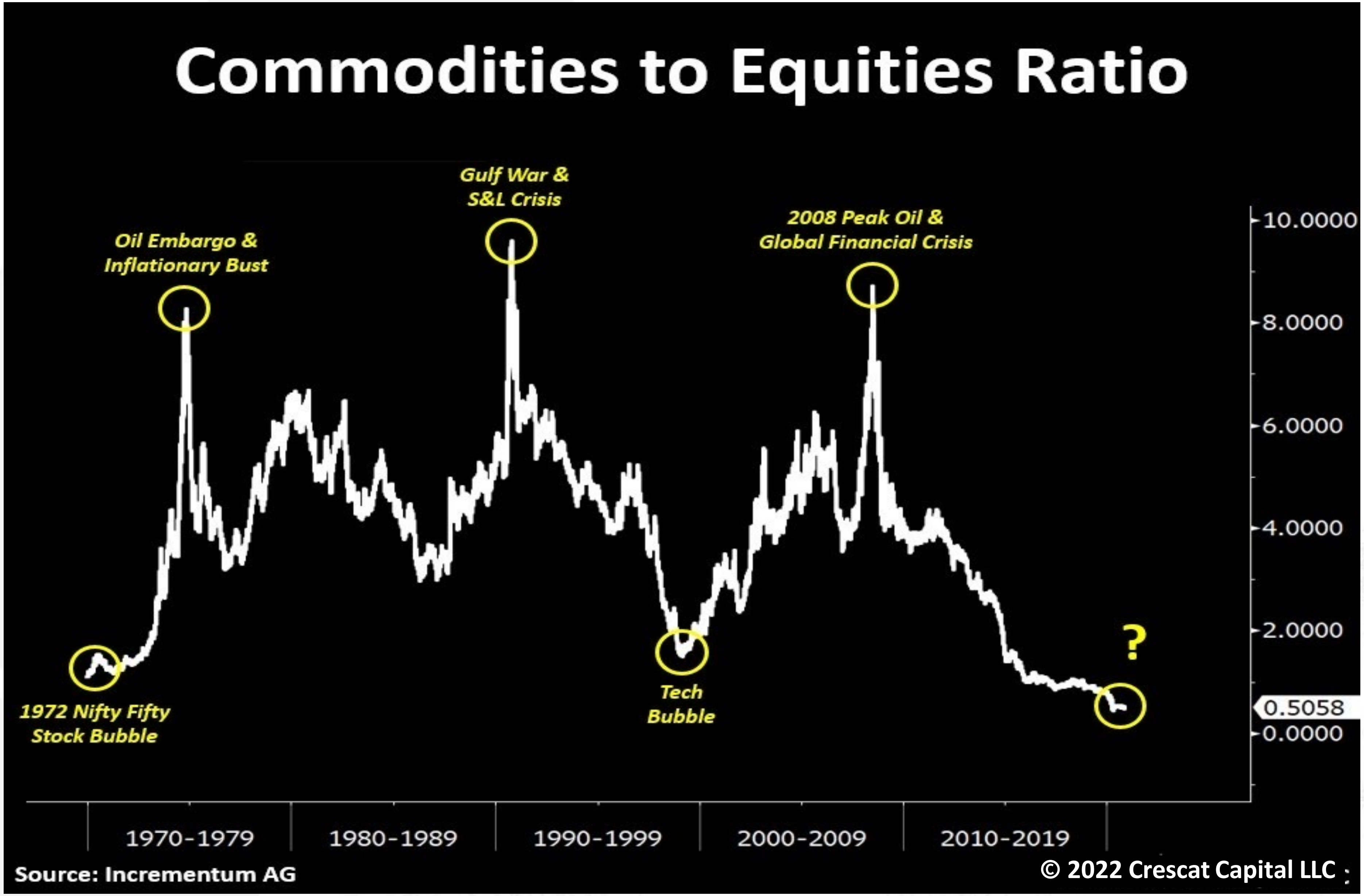


Never have US stocks had a 30% drawdown while investment-grade credit spreads stayed sub 200 basis points according to the Bloomberg US Aggregate Corporate Bond Index. Until now. But that condition is not likely to last much longer. A blowout in corporate default risk is the next chapter to unfold.



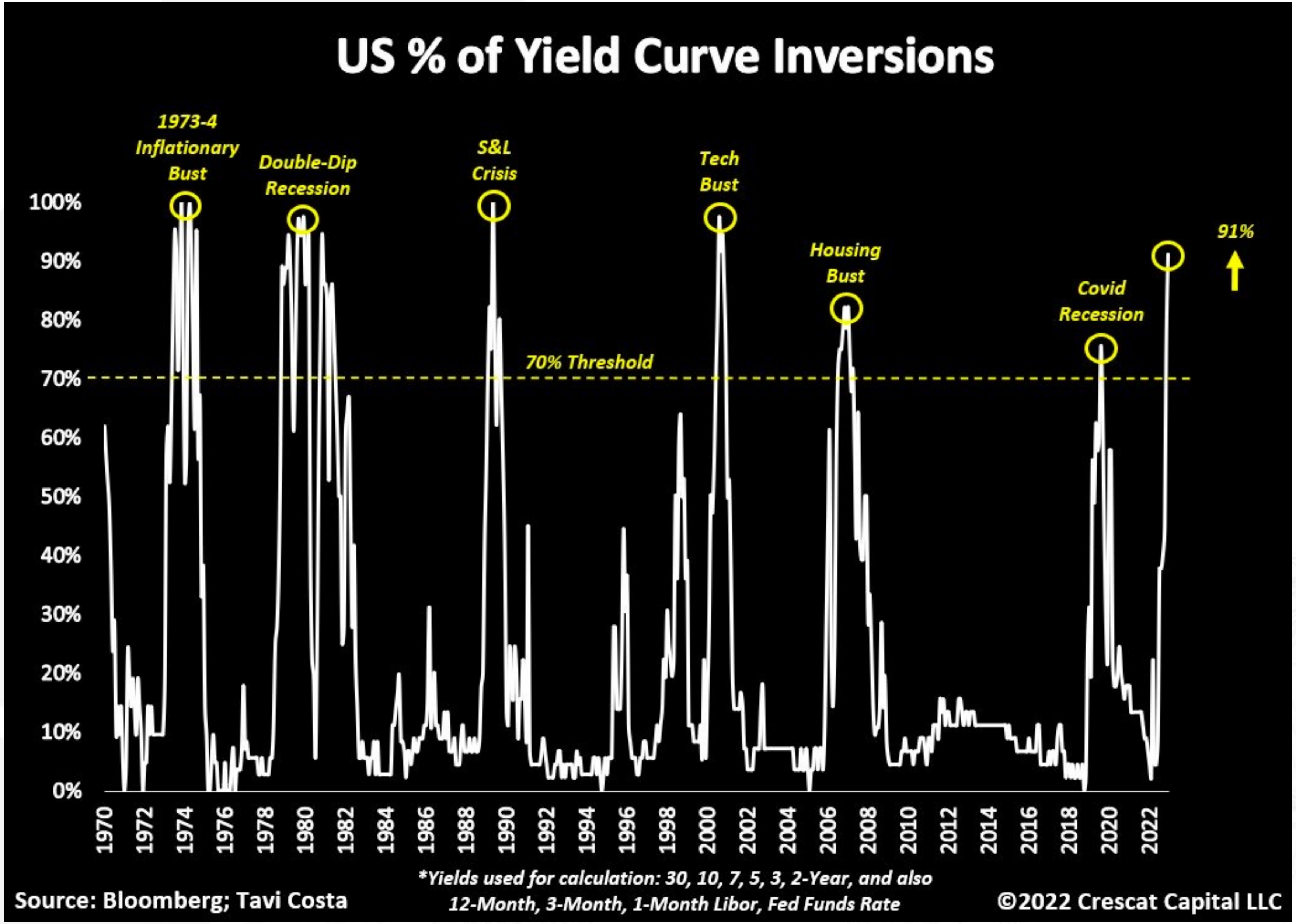
With the Fed tightening financial conditions, the availability of capital to invest in natural resource projects is also drying up.

We believe supply constraints are likely to stay with us for a long time.



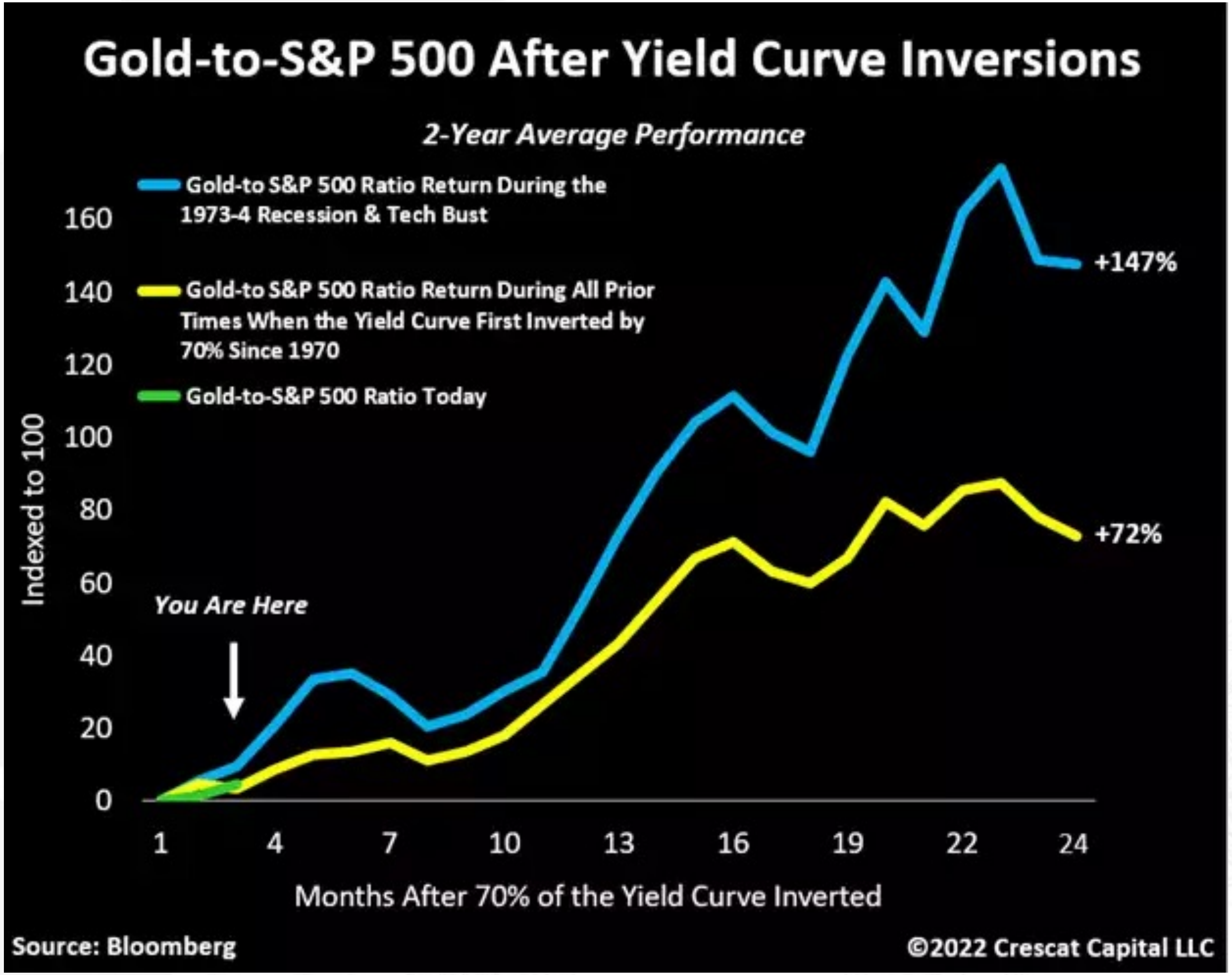
It is still very early, in our analysis, in the rotation cycle out of overvalued growth equities and low-yielding fixed-income securities and into commodities. It is just like early 1973 and early 2001 in our view.

The commodities-to-equity ratio is at a 50-year low.



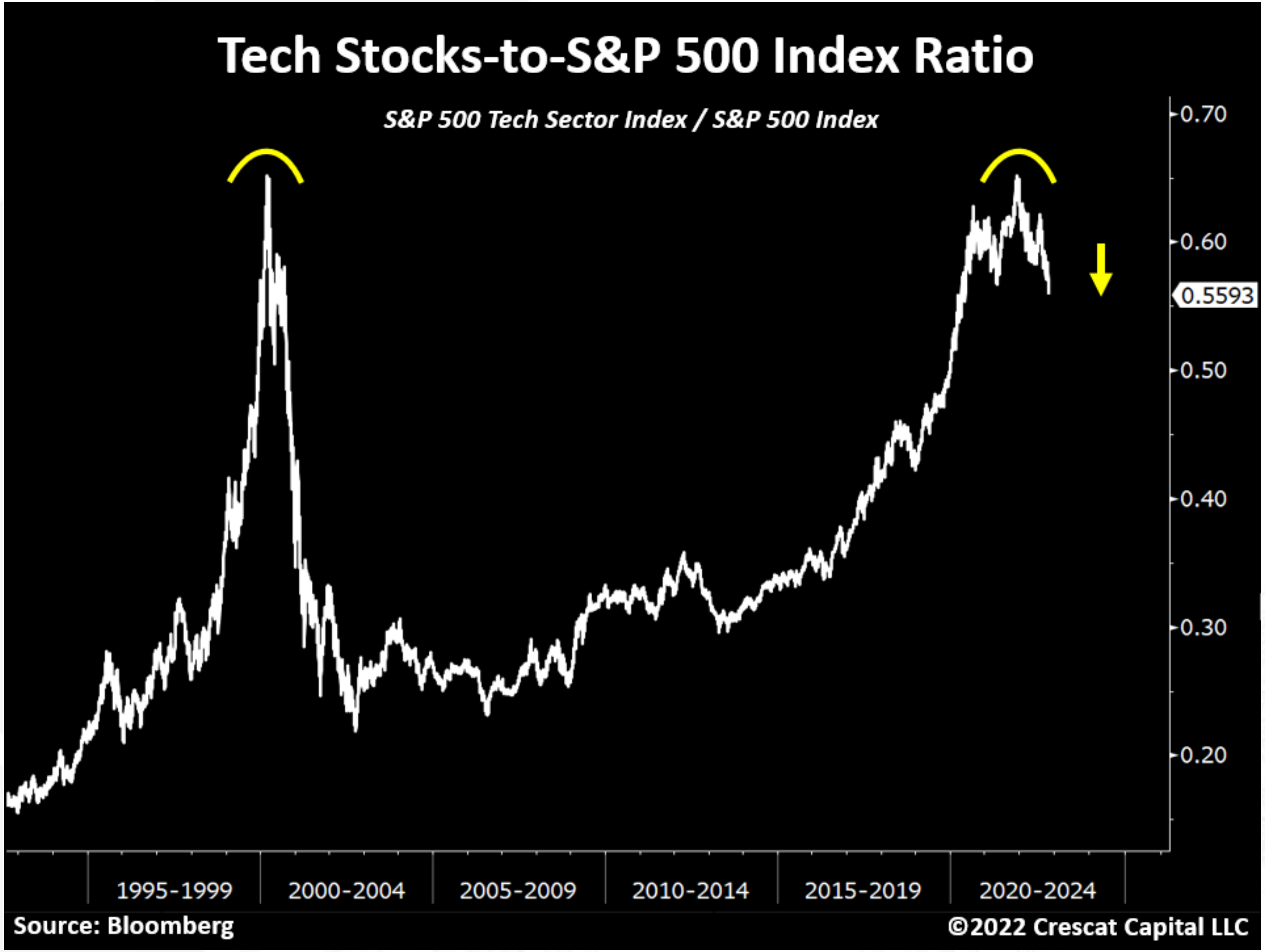
Every time the percentage of yield curve inversions across US Treasuries went above the 70% handle, it coincided with a steep recession since 1970.

More importantly, for portfolio positioning purposes, this indicator gives our strongest macro signal to buy gold and sell stocks.



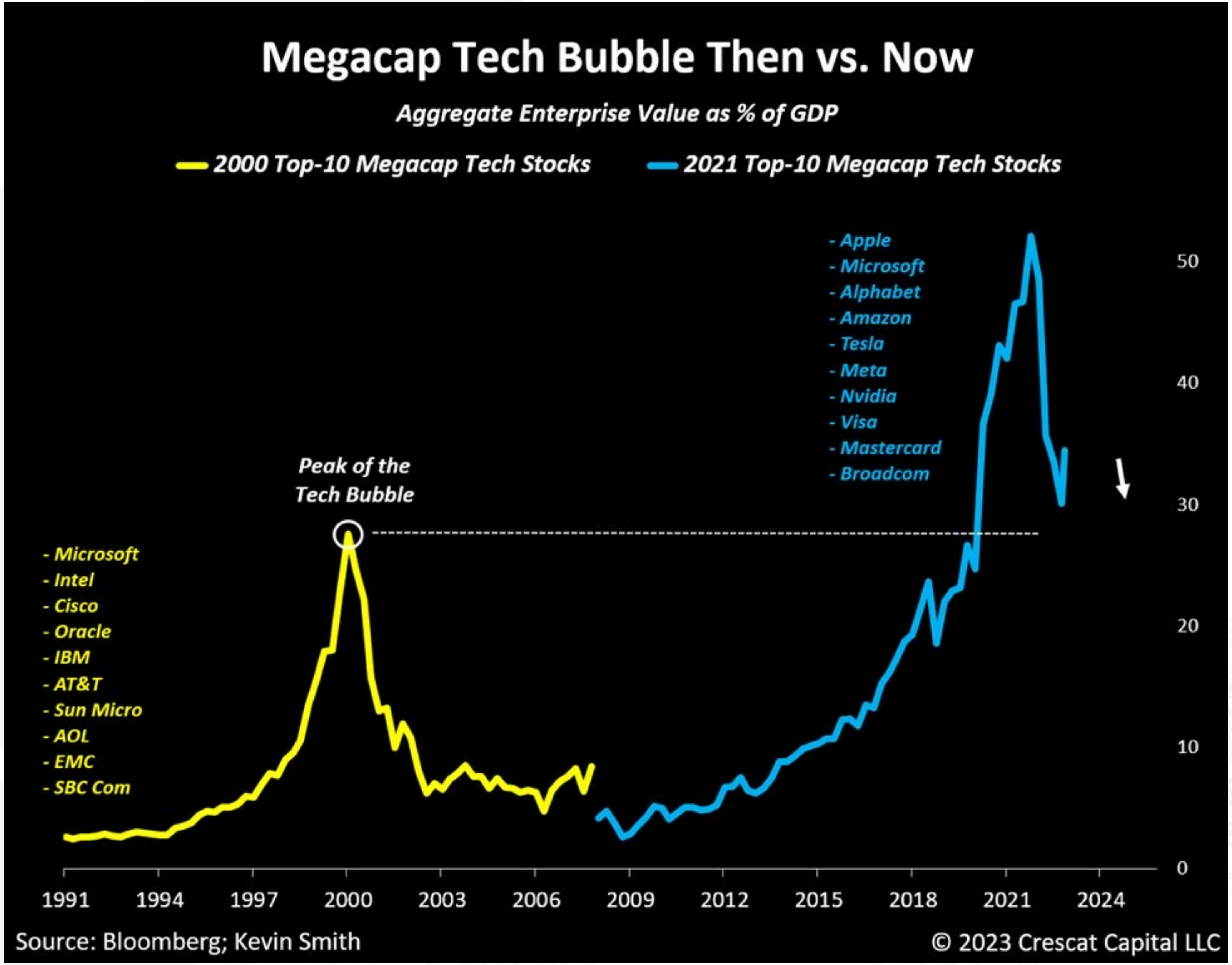
Our work has identified what was a highly profitable macro trade over the next two years following the triggering of this indicator.

The macro trade was simply to buy gold and sell short the S&P 500 Index.



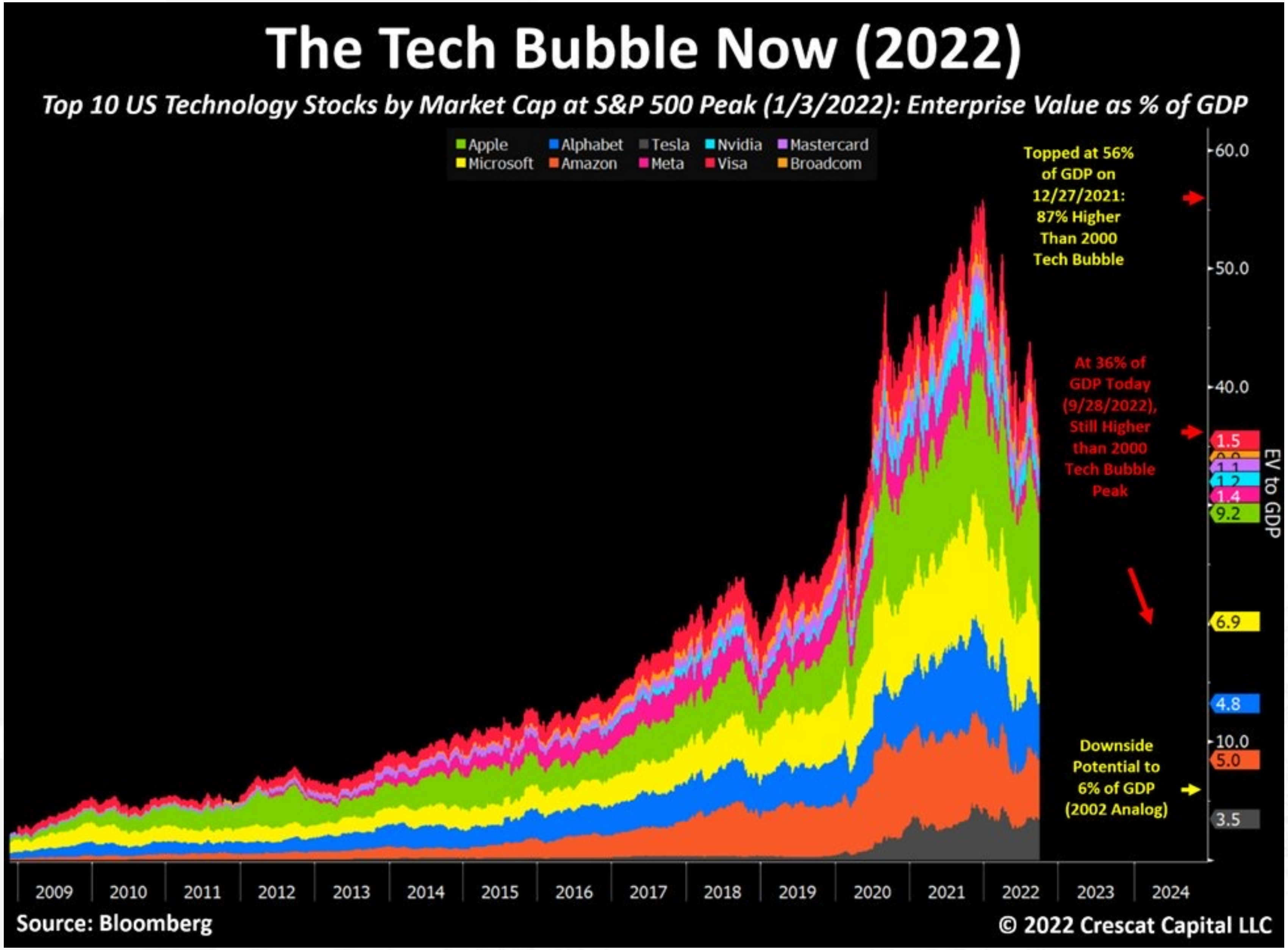
Tech stocks remain historically overvalued relative to the overall equity market.

The tech stocks-to-S&P 500 ratio just recently re-tested the highs of the tech bubble.

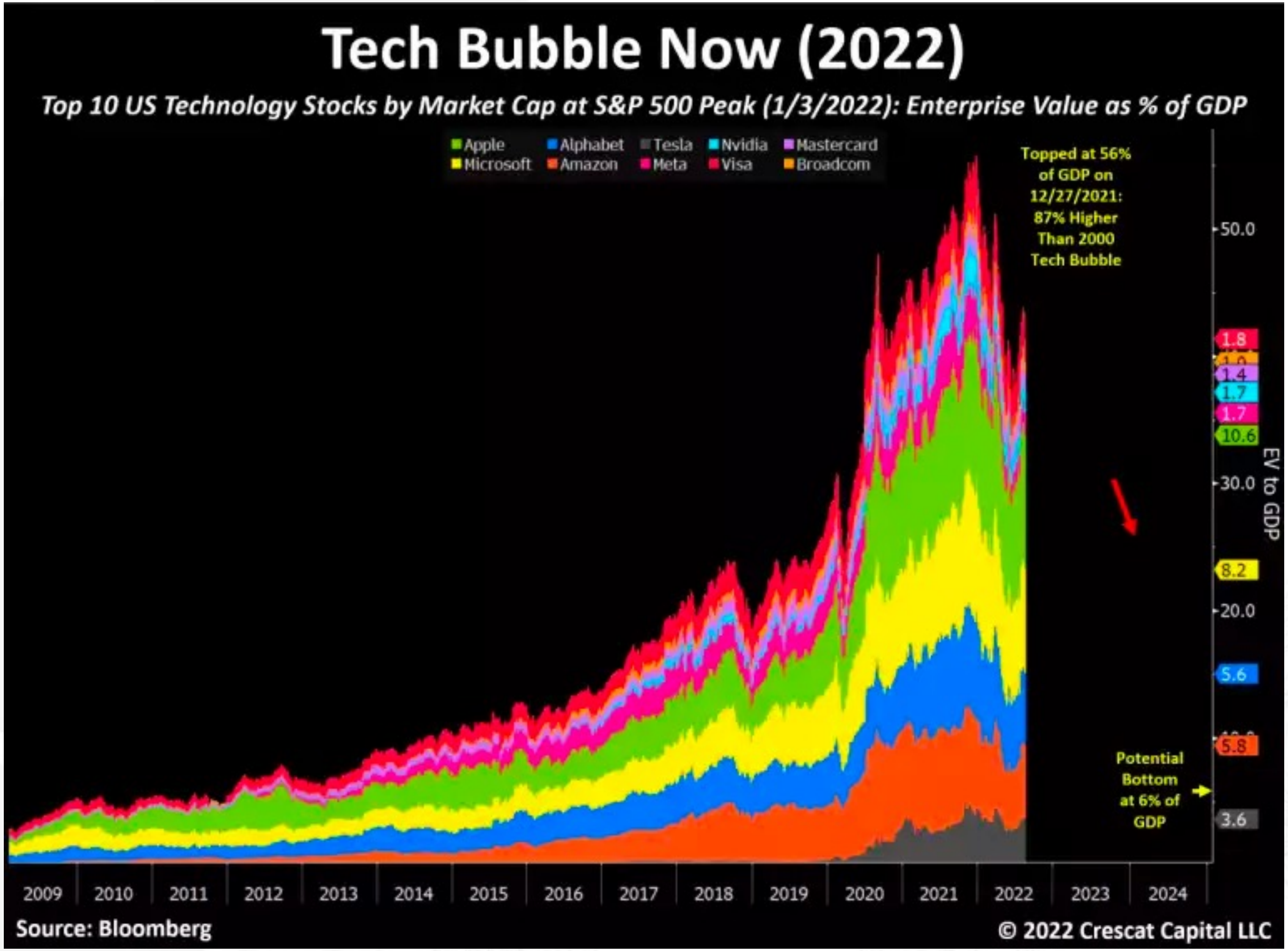


Valuations for the top-ten megacap tech stocks are still higher than they were for their comps at the peak of the tech bubble.

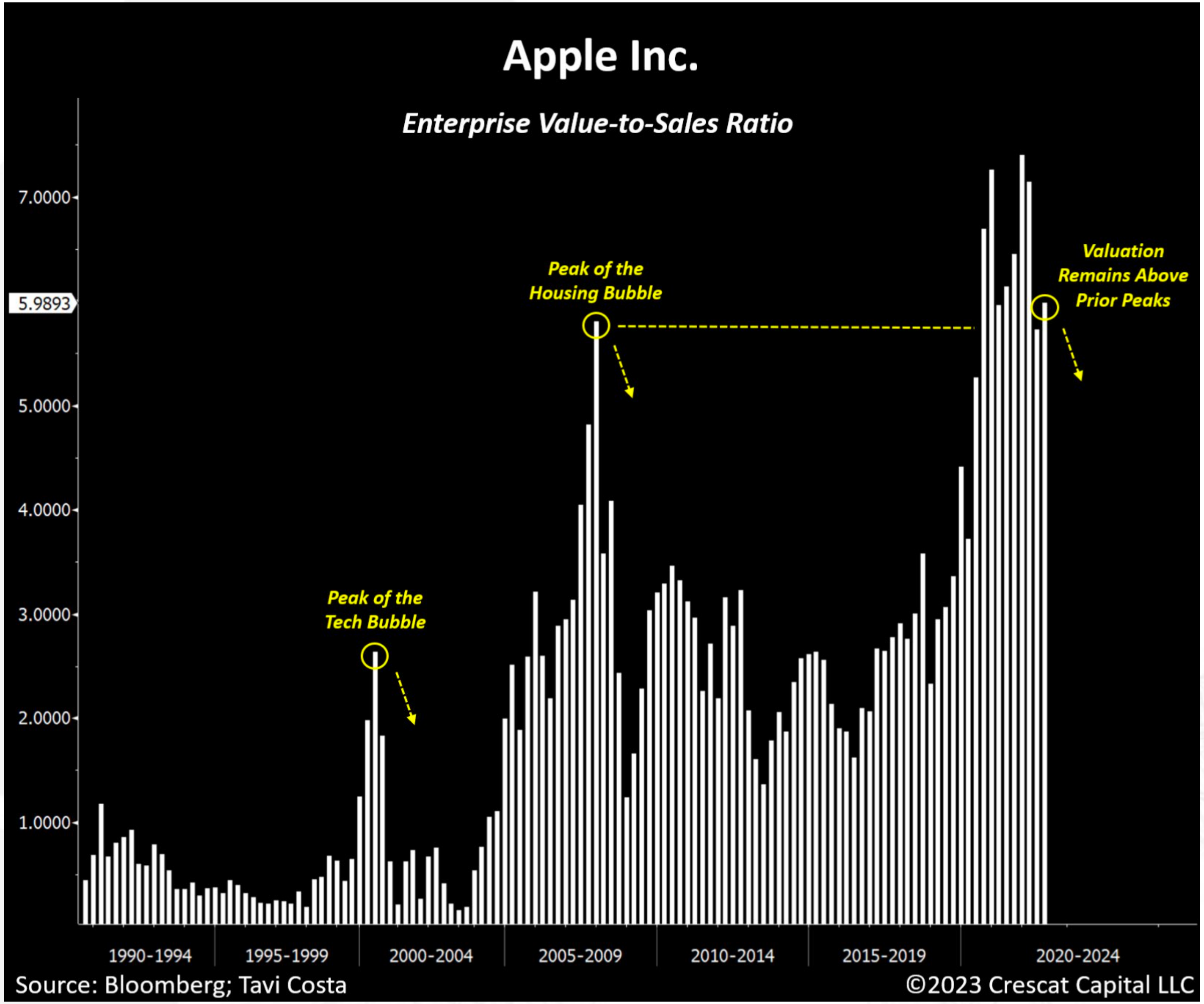
Enterprise Value to GDP is the relevant measure here because once the underlying fundamentals for a group of companies have grown so large relative to the economy, as it has for these firms, then collectively, these companies can no longer grow any faster than the economy at large.



By March 2000, the leading five US market cap companies combined were valued at a then-record 24% of the economy based on enterprise value to GDP.

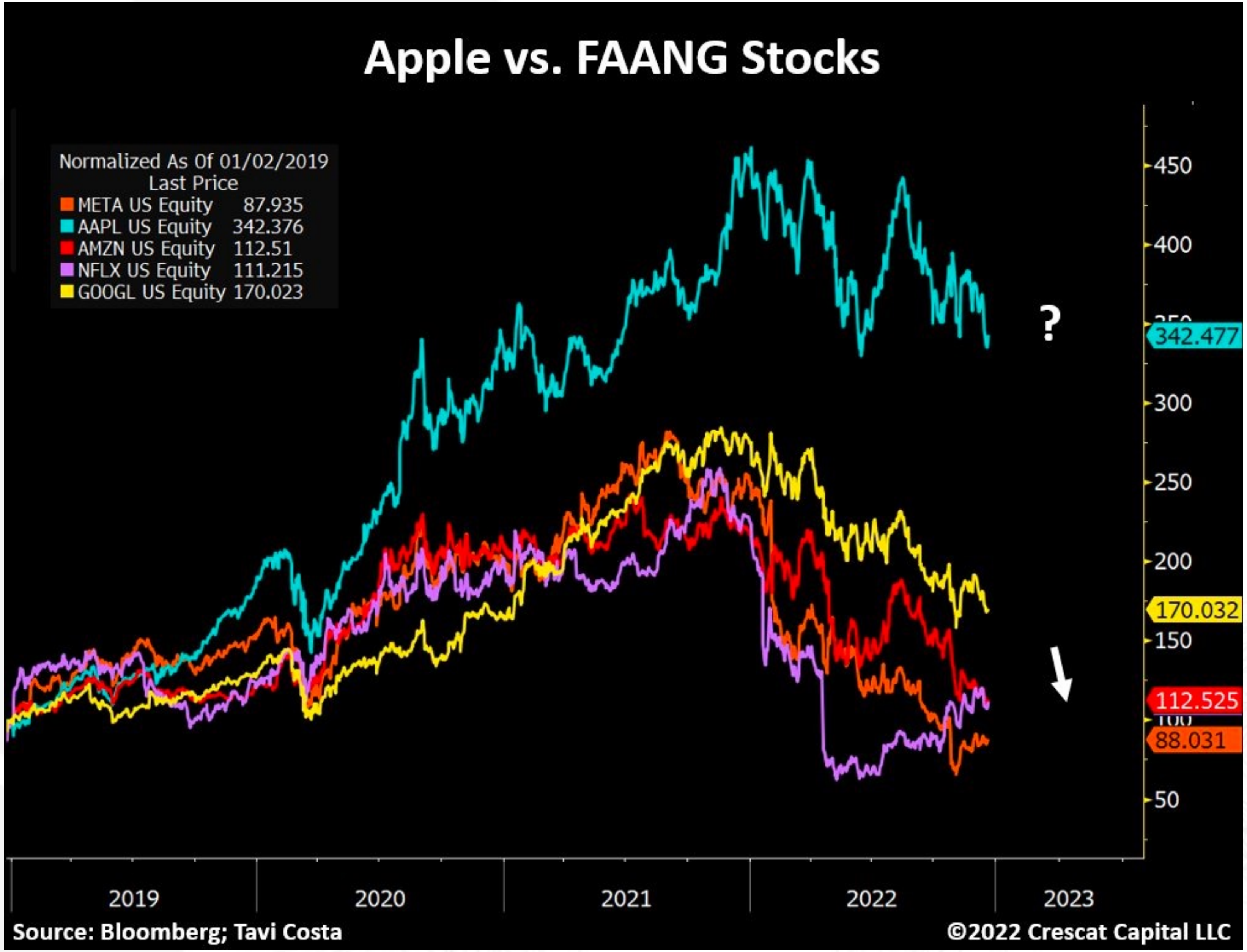


Today, the combined enterprise value of the widely help top five is 37% of GDP, 54% higher than it was for the top five at the peak the 2000 peak.

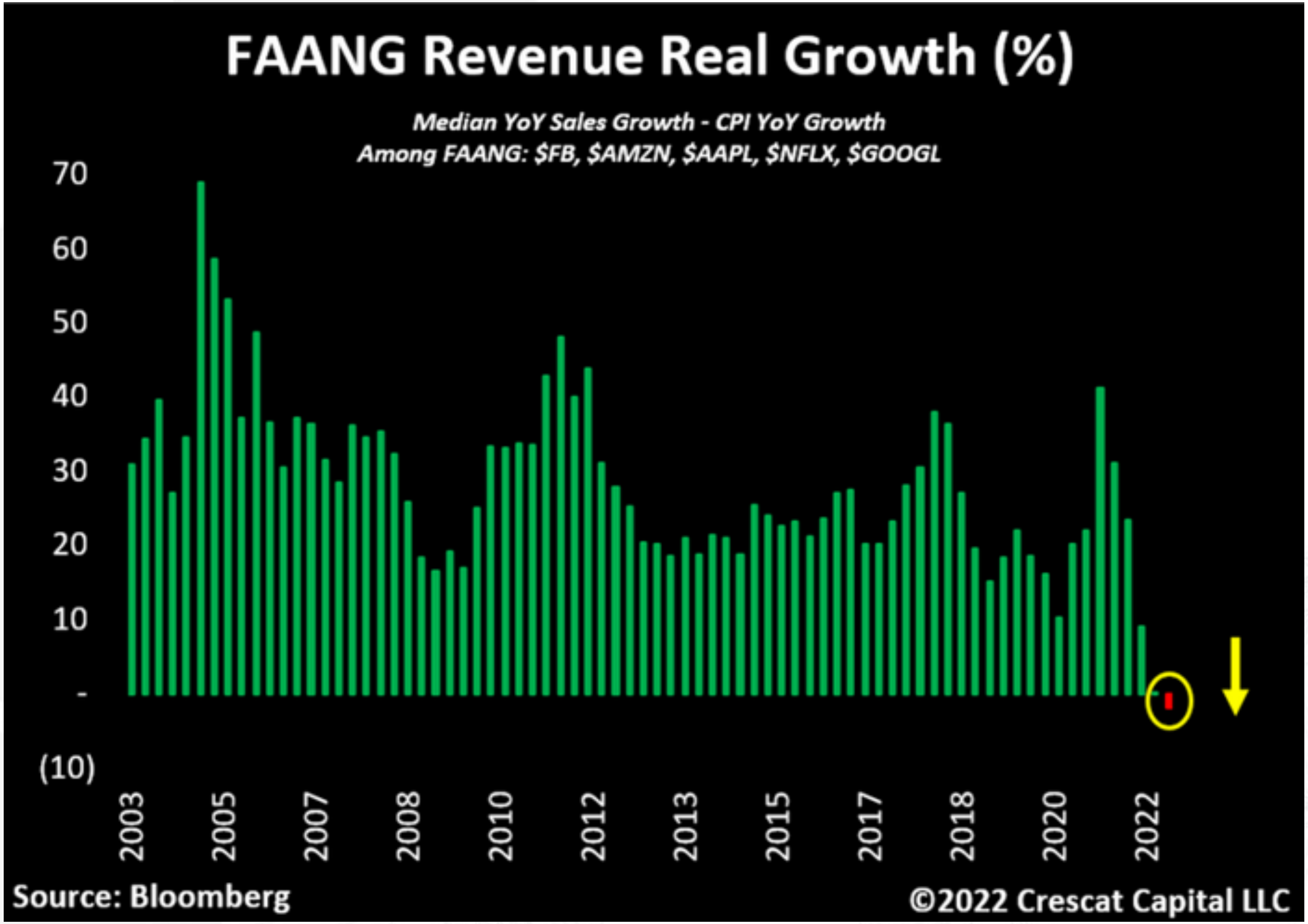


Apple still has one of the most expensive valuations in its history.

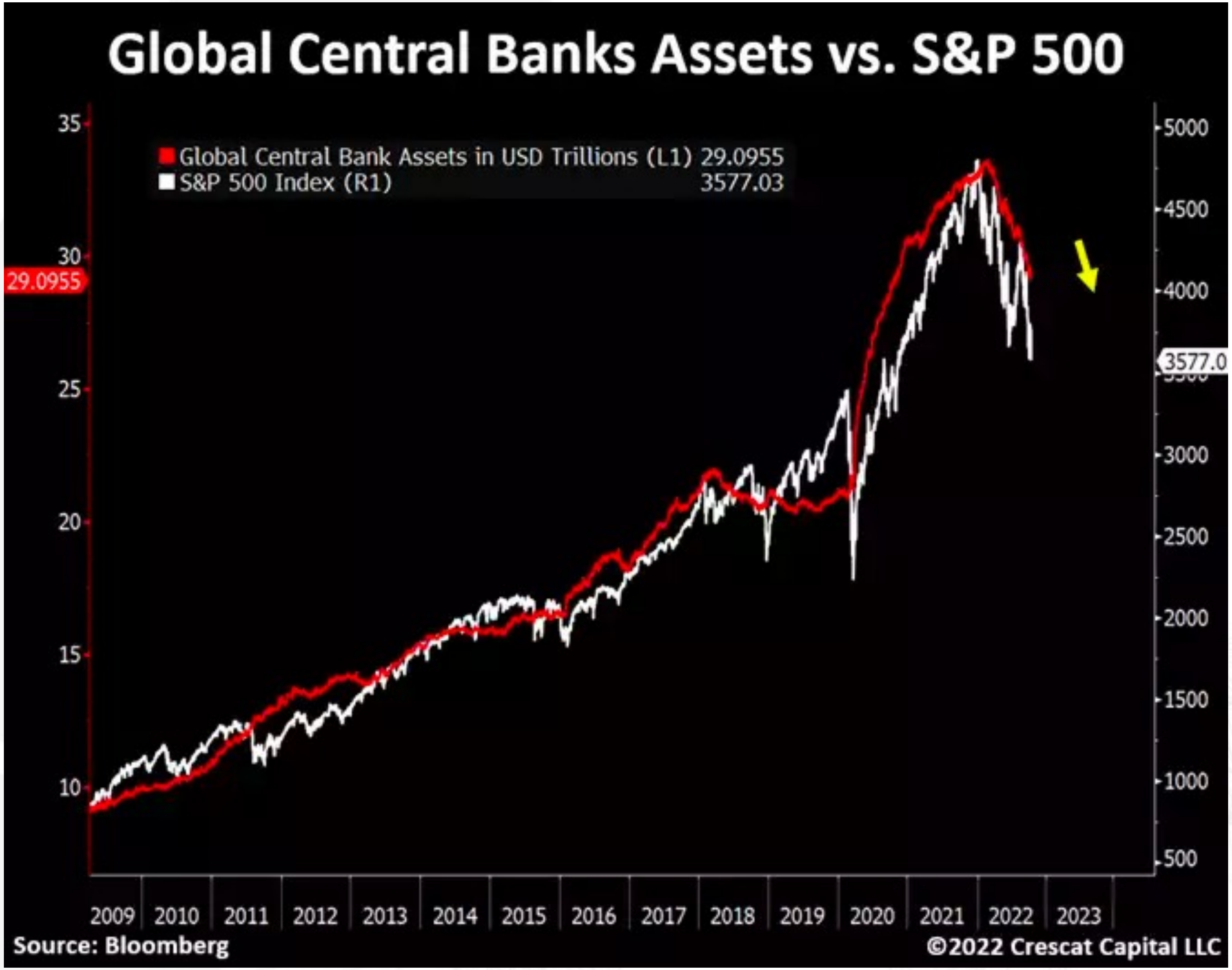
EV to sales is currently 2x the level it was at the peak of tech bubble.



A reminder that Apple is a consumer discretionary business trading at 22x next year's earnings as the economy enters a steep recession.

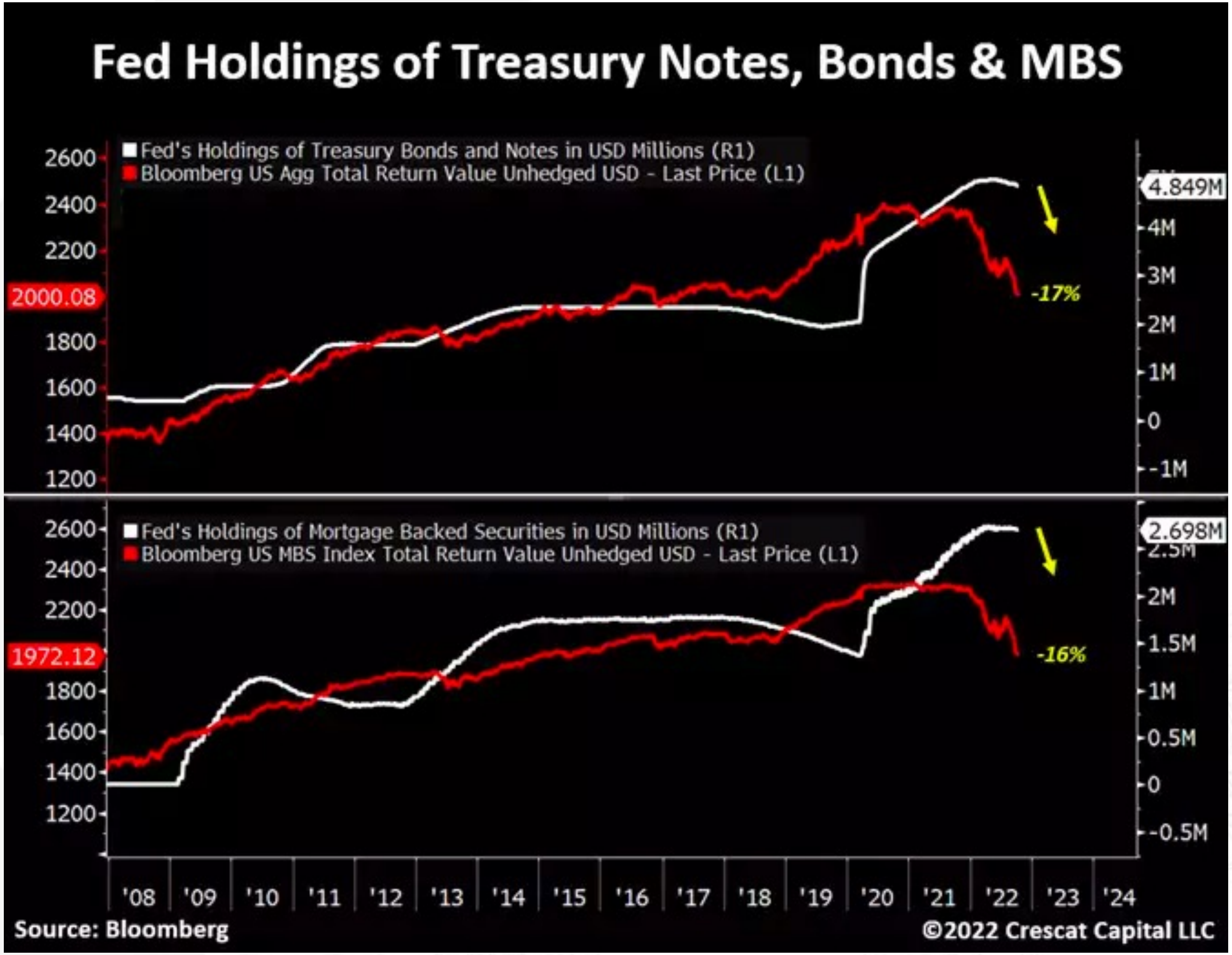


The median real revenue growth for the FAANG stocks has officially turned negative for the first time in almost 2 decades.

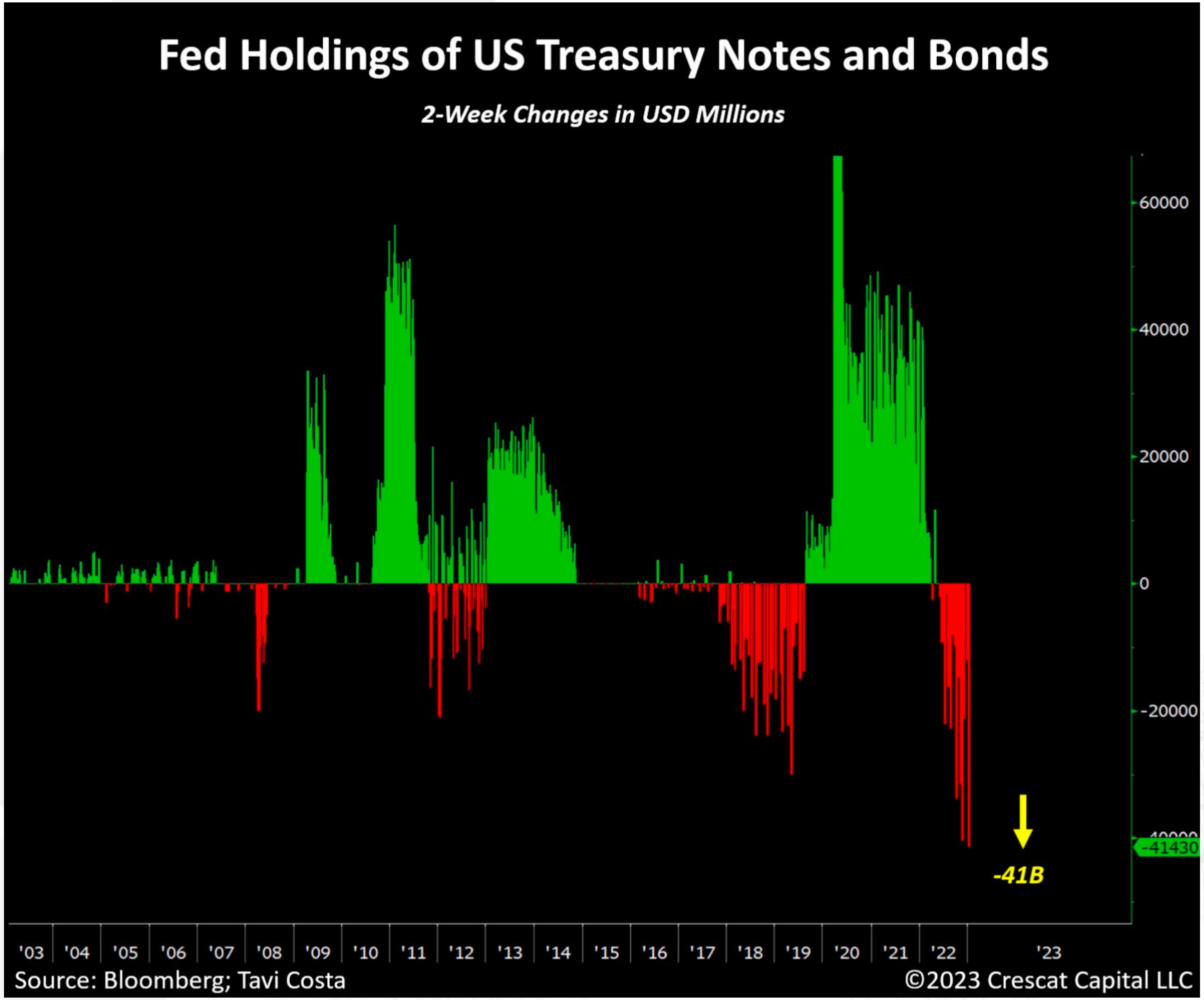


There is a strong correlation between equity markets and global central bank assets is undeniable.

The issue with this chart, however, is that it assumes that the Fed still holds close to $9 trillion in assets in its balance sheet, and that is grossly overstated.

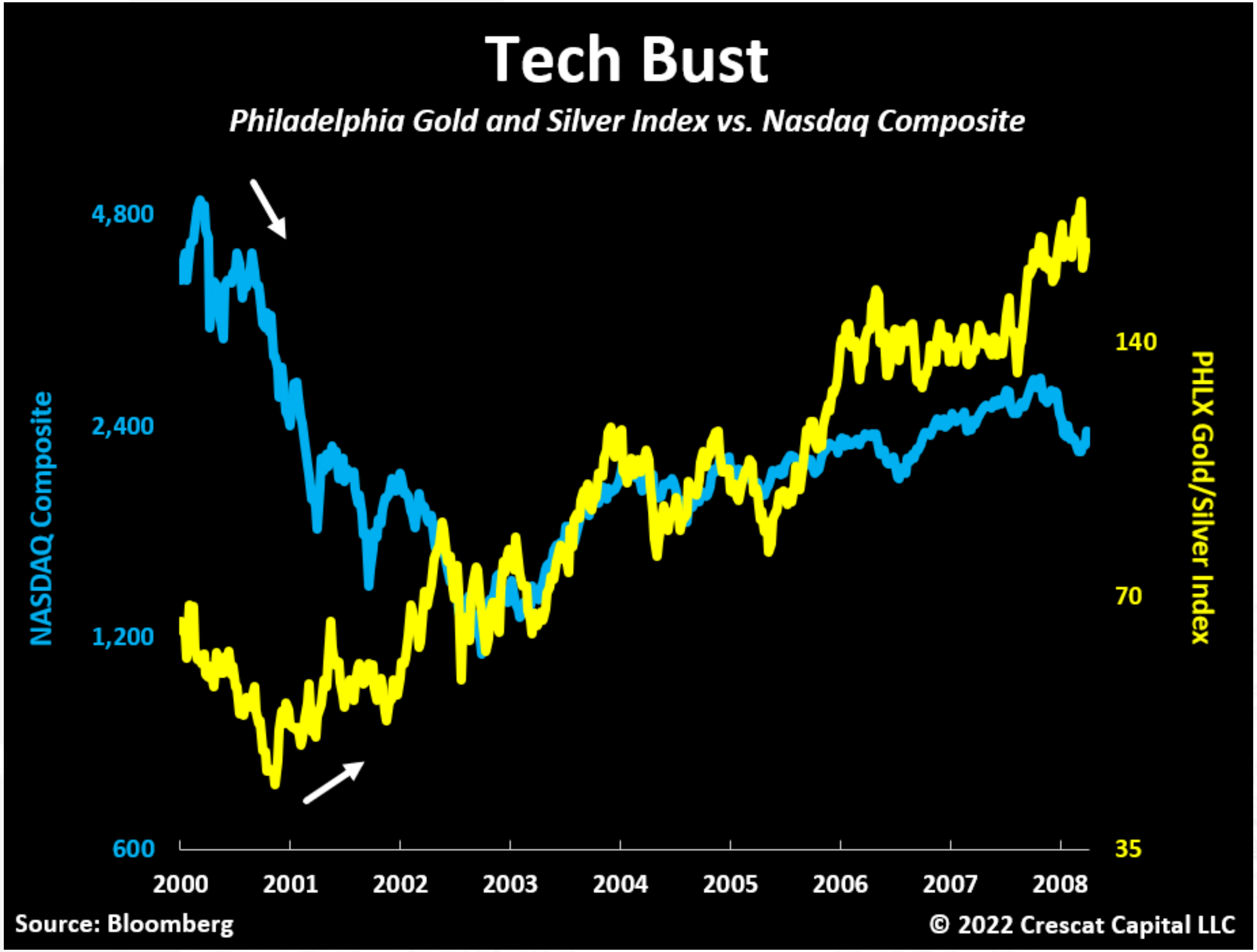


Among Treasury notes, bonds, inflation-indexed and mortgage-backed securities, we calculate that the valuation of the Fed's assets has declined by almost $1.5 trillion.

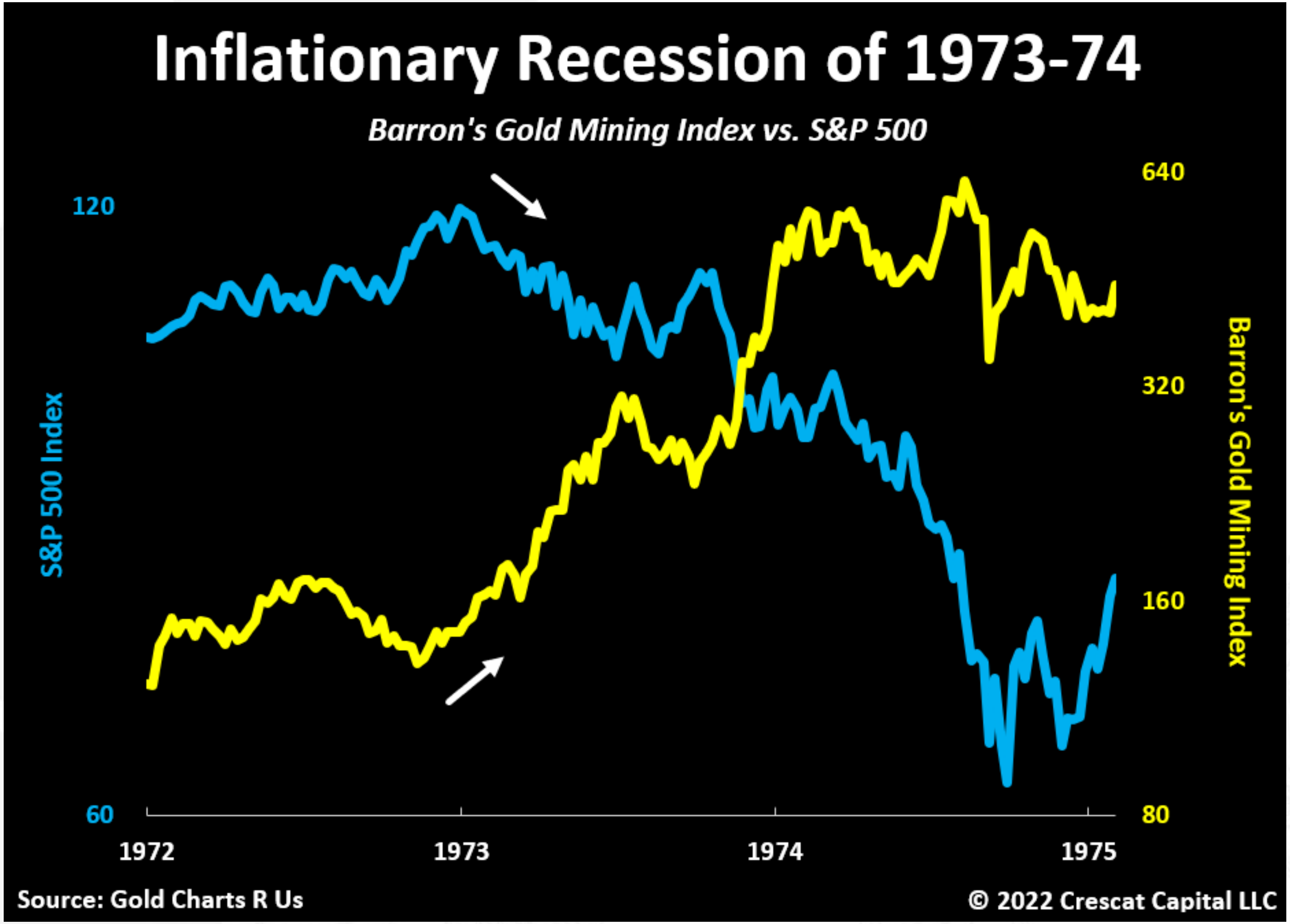


The Fed holdings of US Treasury notes and bonds just fell by the largest amount in history.

Over $41 billion just in the last 2 weeks.

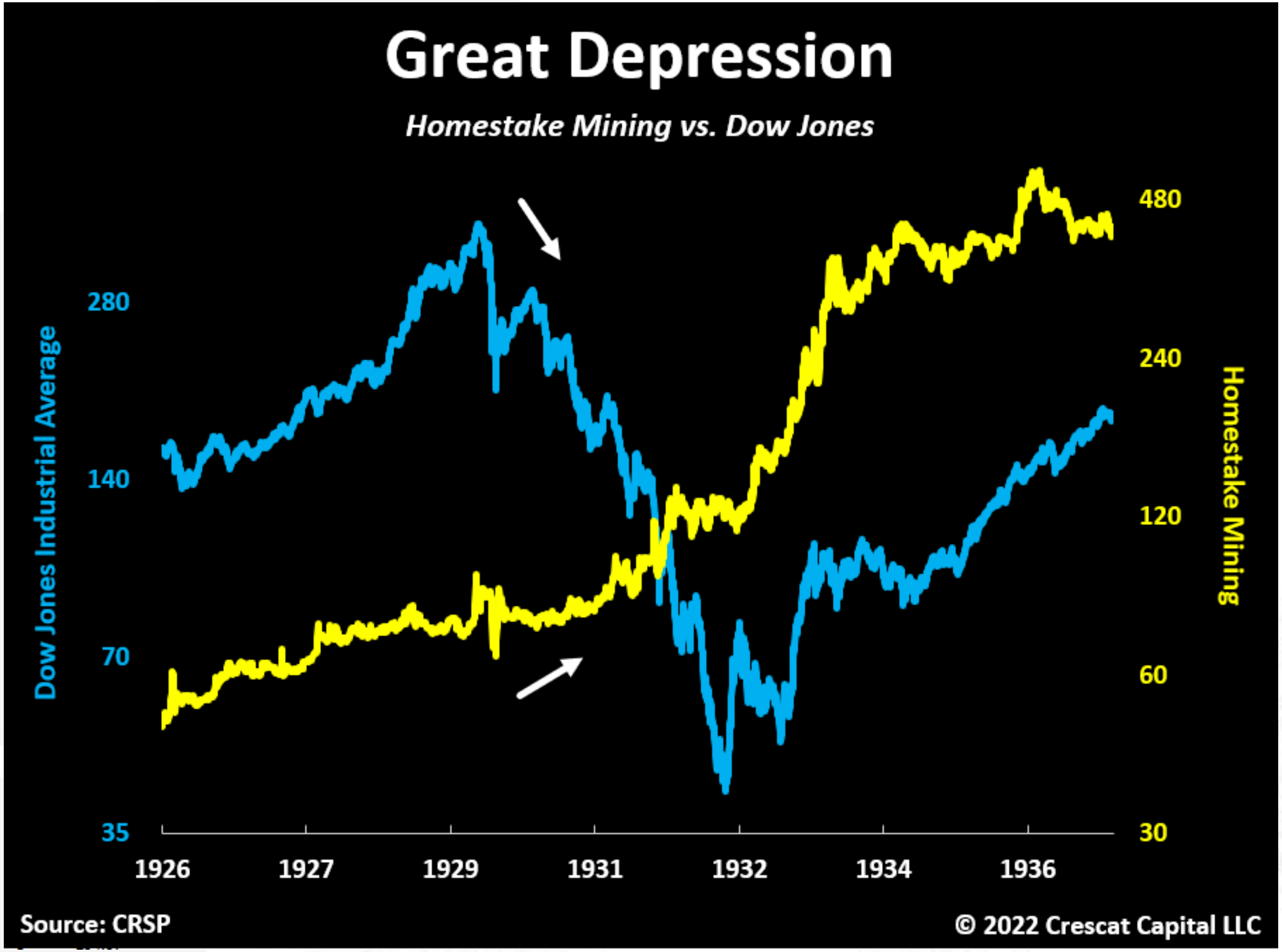


In the early 2000's tech bust, NASDAQ continued to fall all the way to October 2002, but the great buying opportunity for precious metals mining stocks started at the end of 2000.



In 1973 to 1974, mining stocks went up 5-fold in just two years while the S&P 500 declined 50%

Large-cap growth stocks known as the Nifty Fifty at the time, the mega-caps of their day, went down substantially more.



Even in that deflationary era, the largest gold mining stock appreciated a whopping 7-fold in five years after the 1929 crash while the Dow Jones finished the same period lower.

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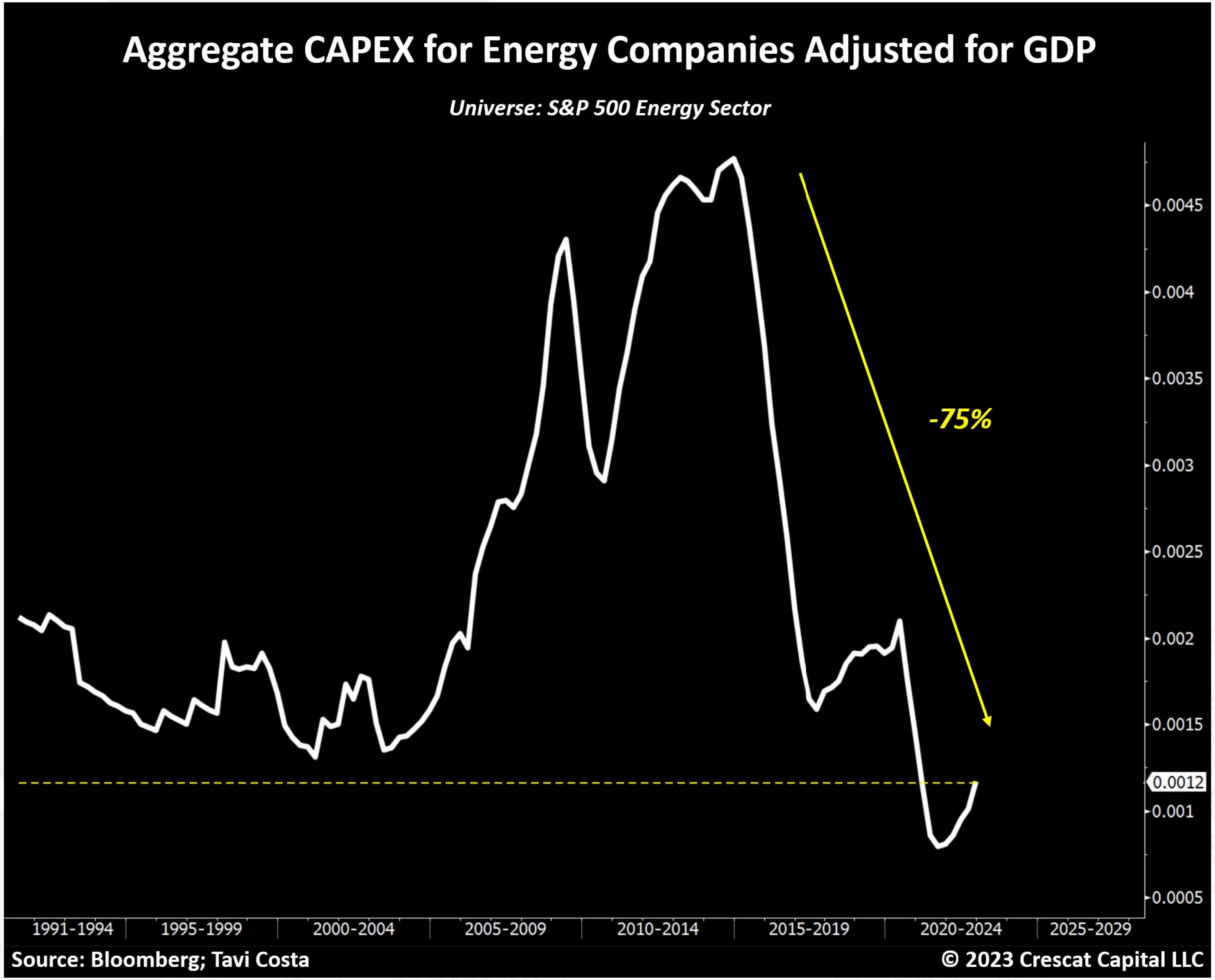
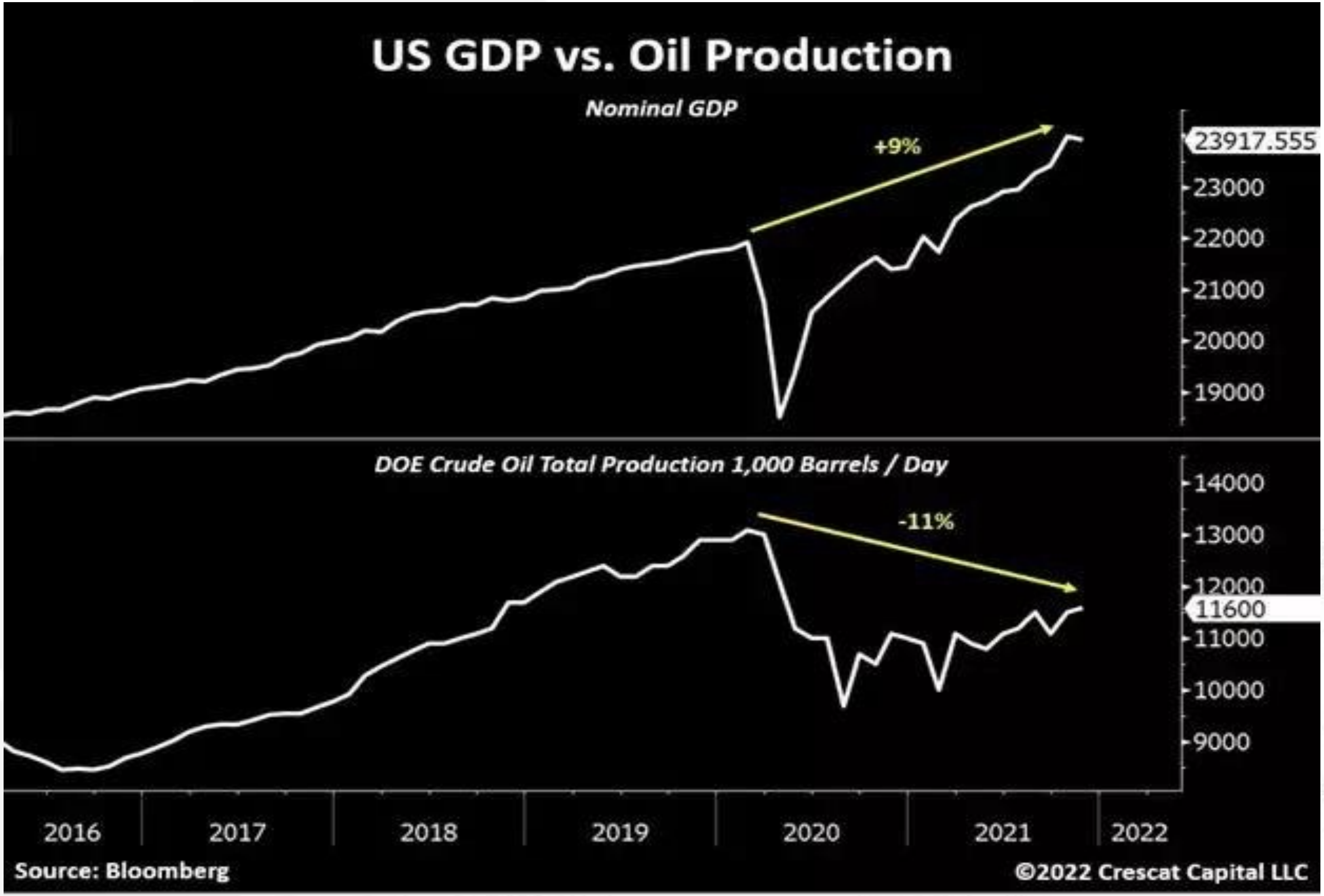
ENERGY TRANSITION

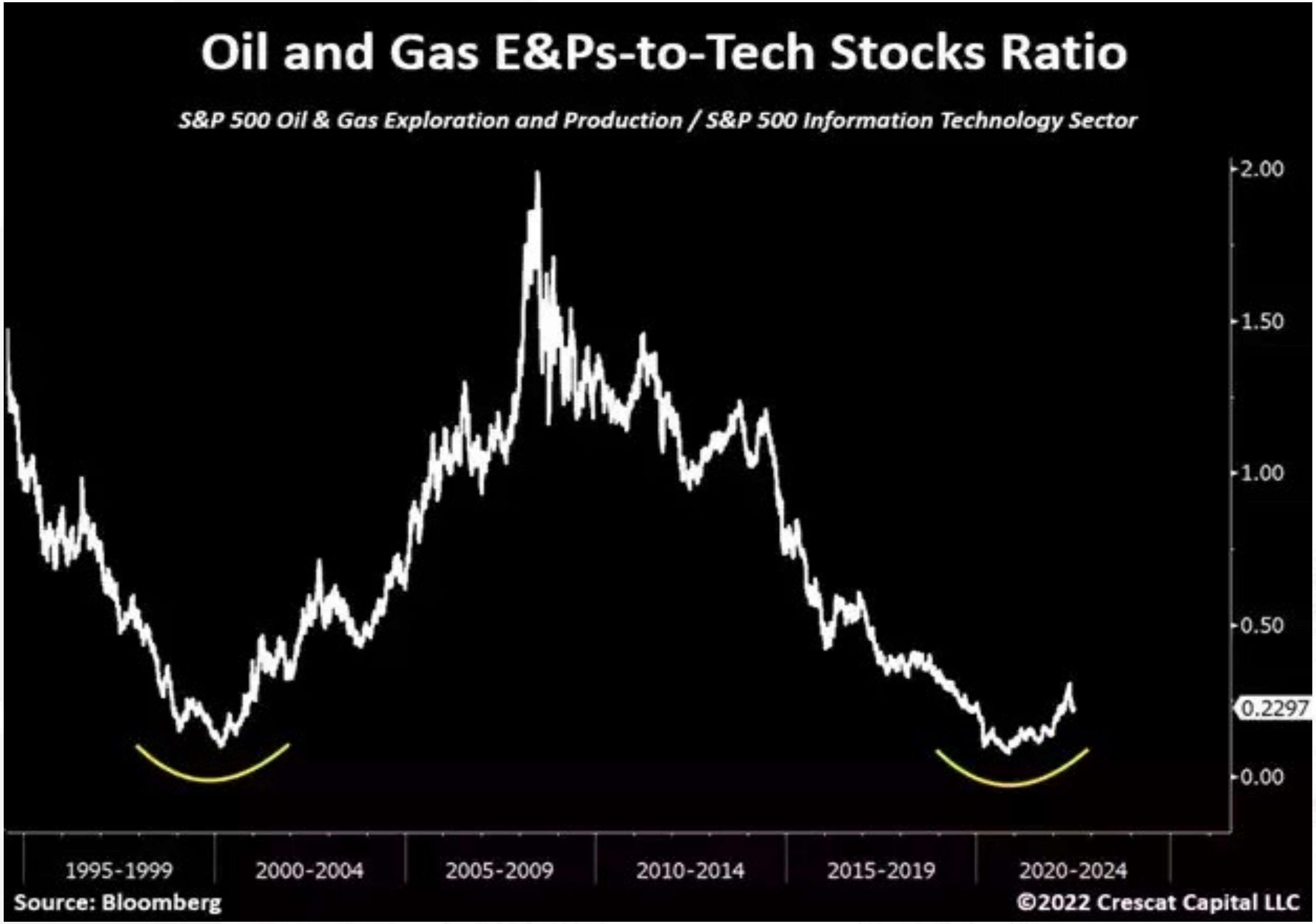


Aggregate CAPEX for energy companies adjusted for GDP levels is still below every other depressed level in the last 30-plus years.

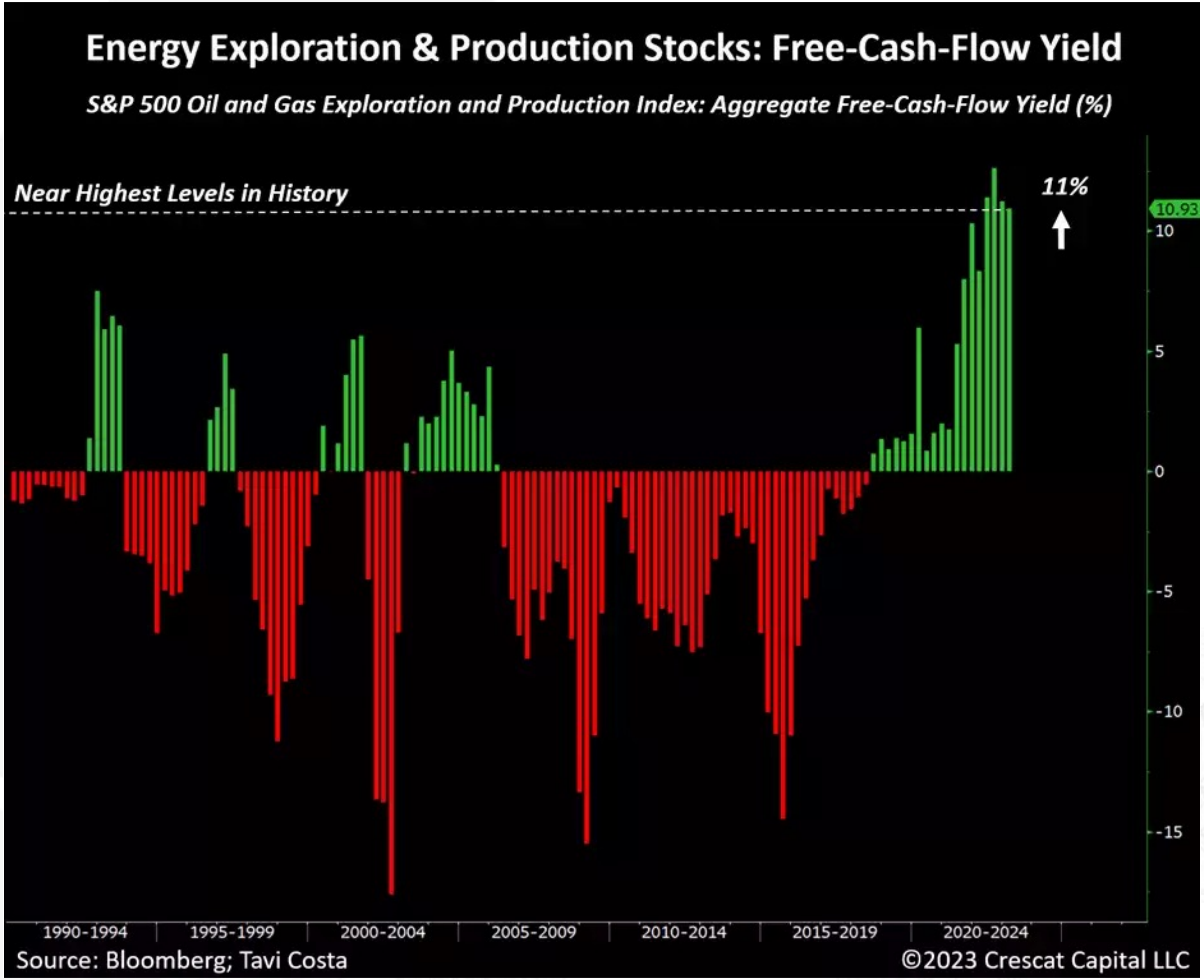
Current levels are over 75% lower than the prior peak.



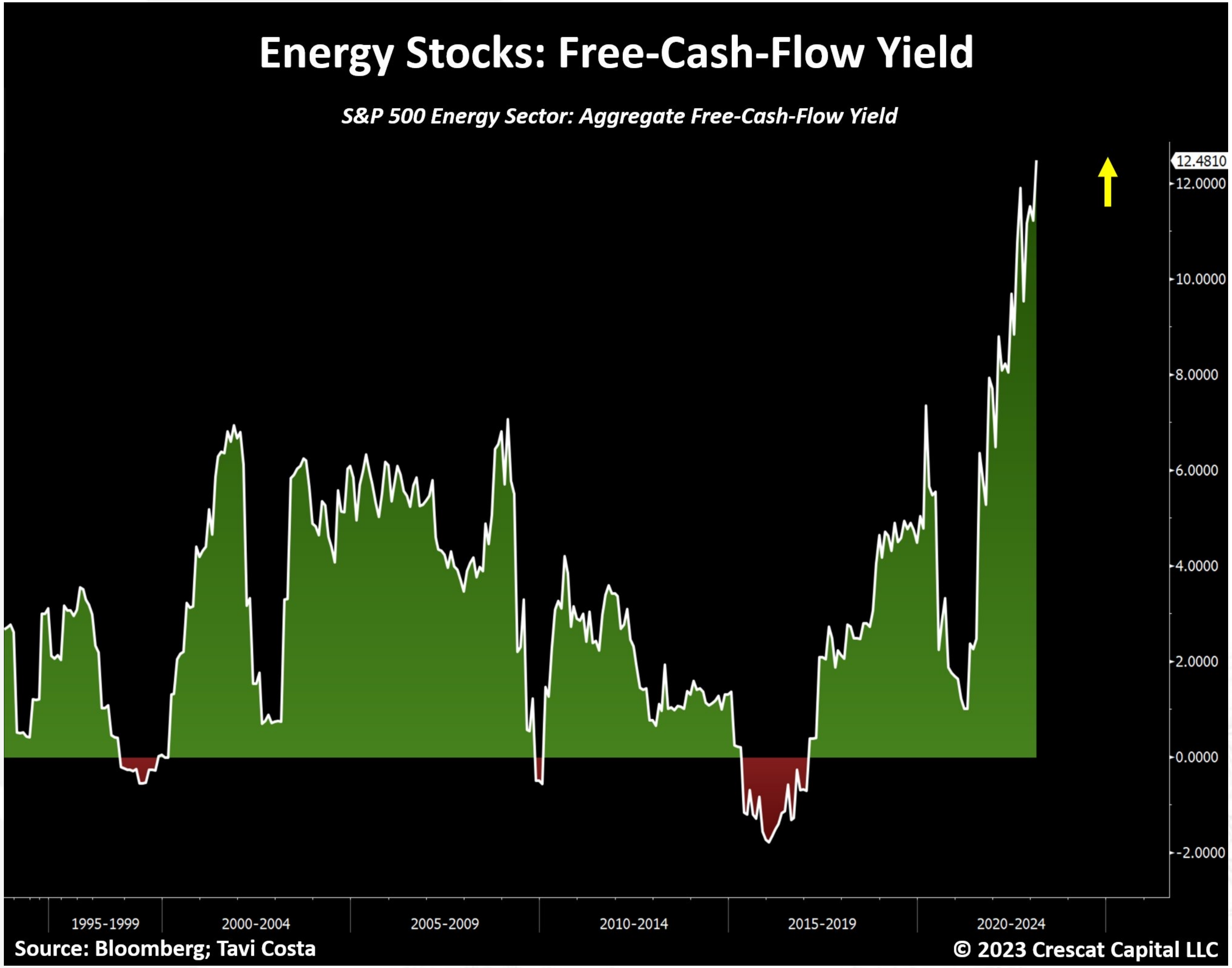
Nominal GDP is well above its pre-pandemic levels while oil production remains significantly below.



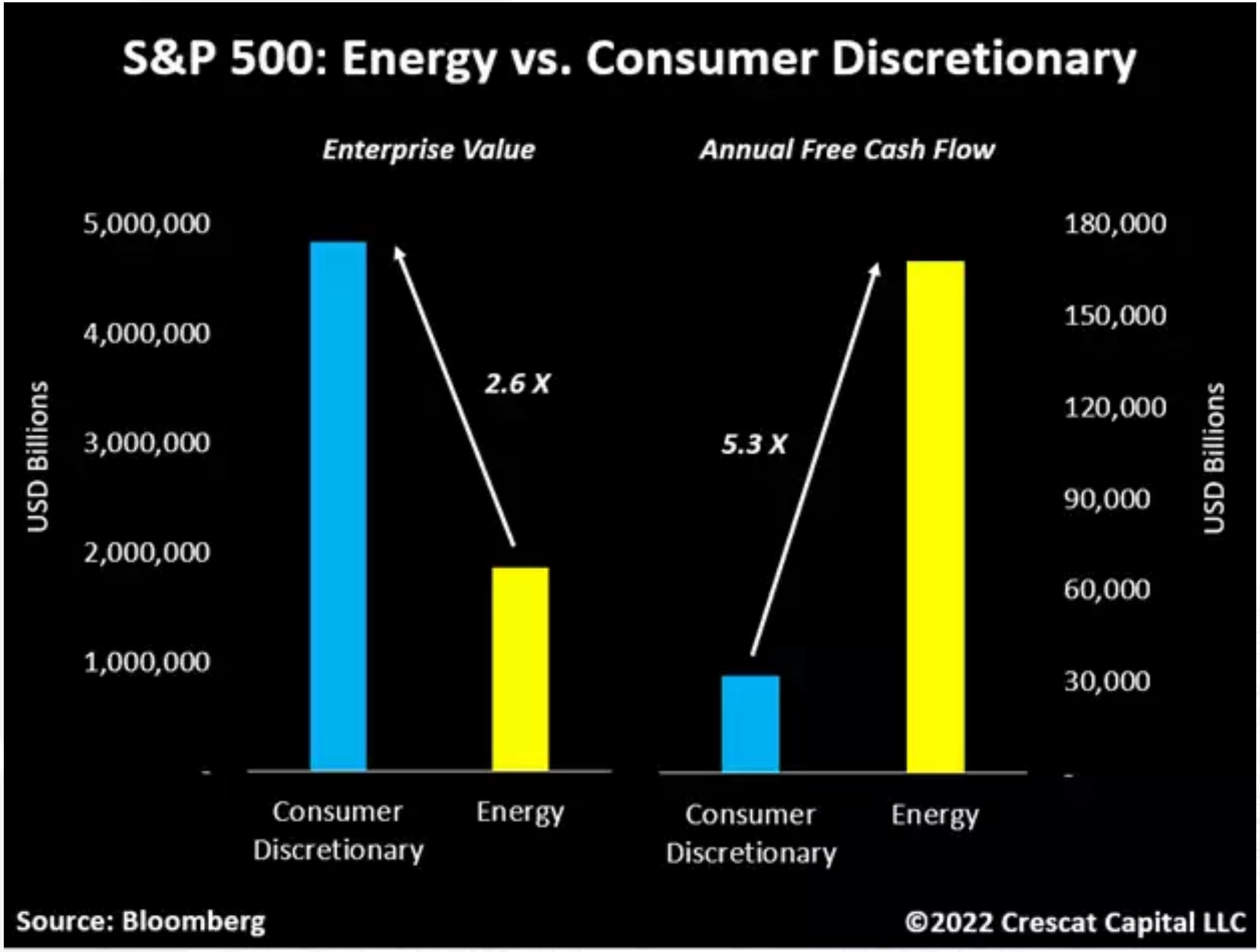
The energy-to-tech stock's ratio is as low as it was at the peak of the tech bubble.



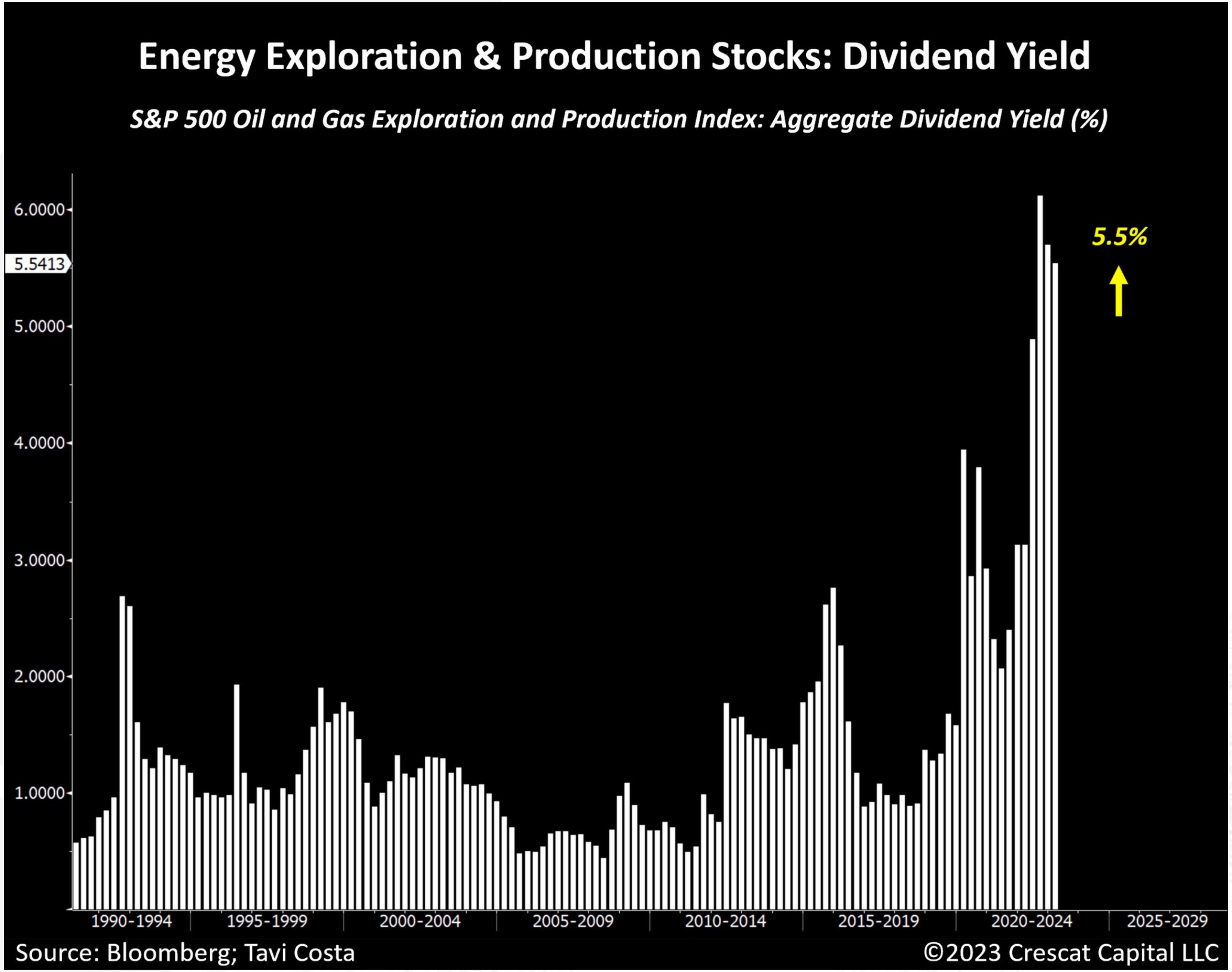
Oil and gas stocks just had their two best annual performances in 30 plus years, and the sector still trades at one of the cheapest levels in history. Aggregate free-cash-flow yield for energy exploration and production companies is now at 11%.



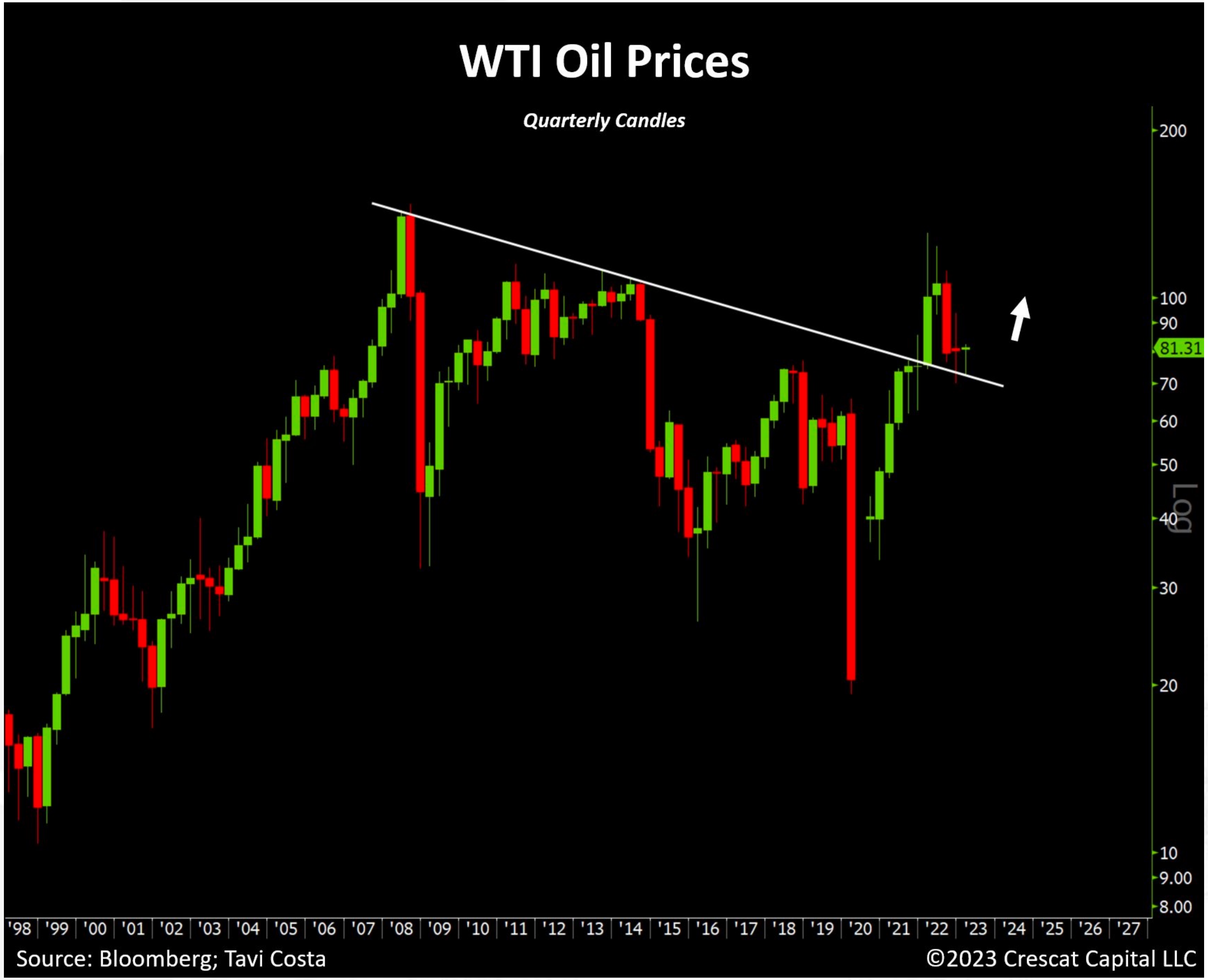
If energy prices strengthen, as we envision due to structural shortages and ongoing demand, these companies are even more of a bargain.



Unsurprisingly, today's consumer discretionary sector is now worth 2.6 times the size of the energy sector, while the latter generates over 5 times more in free cash flow.



Oil and gas exploration & production companies are by far paying their highest dividend yield in history of the data.



What if oil has another big move, inflation re-accelerates, and interest rates need to stay higher for longer? Equity markets would not appreciate this.

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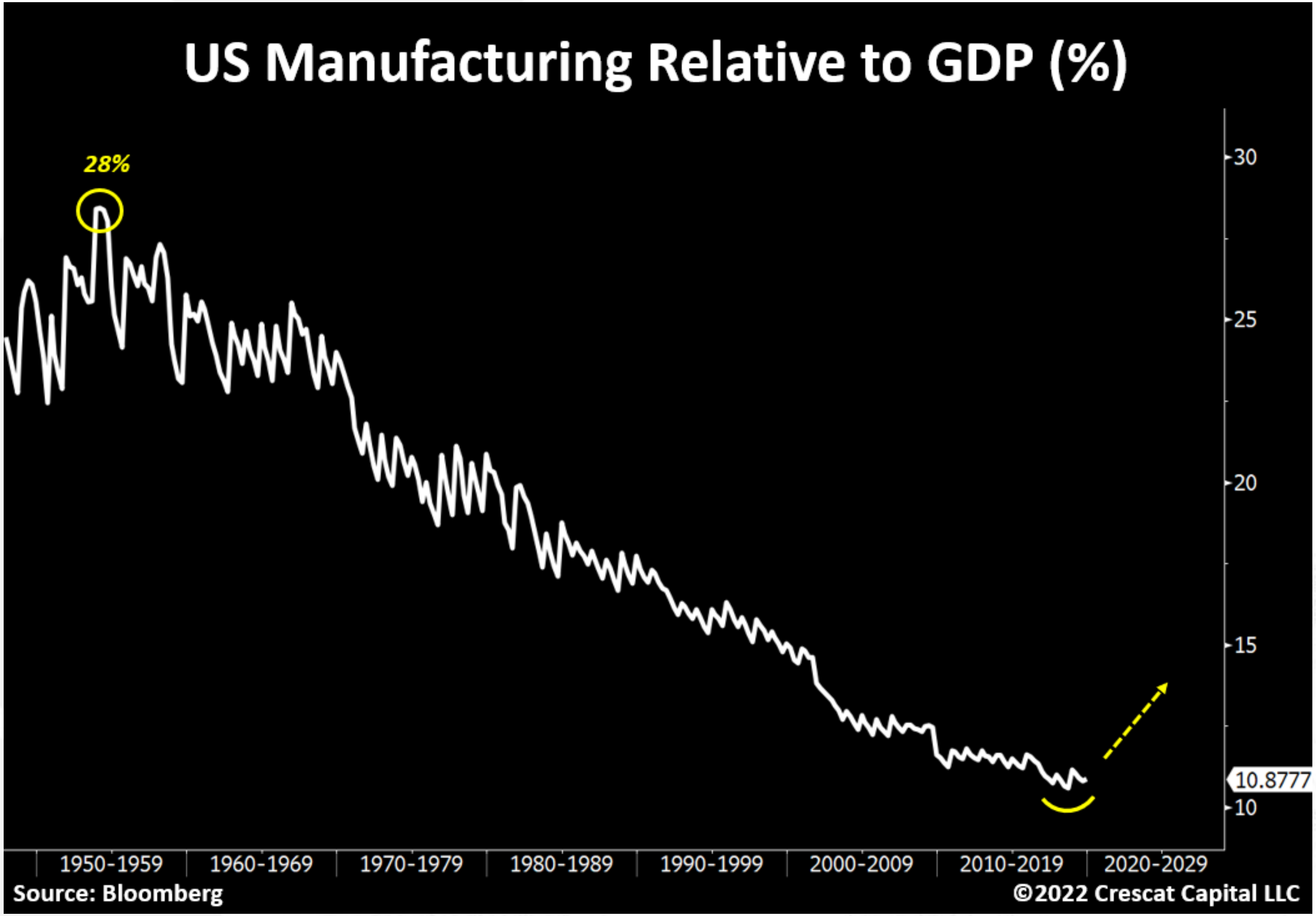
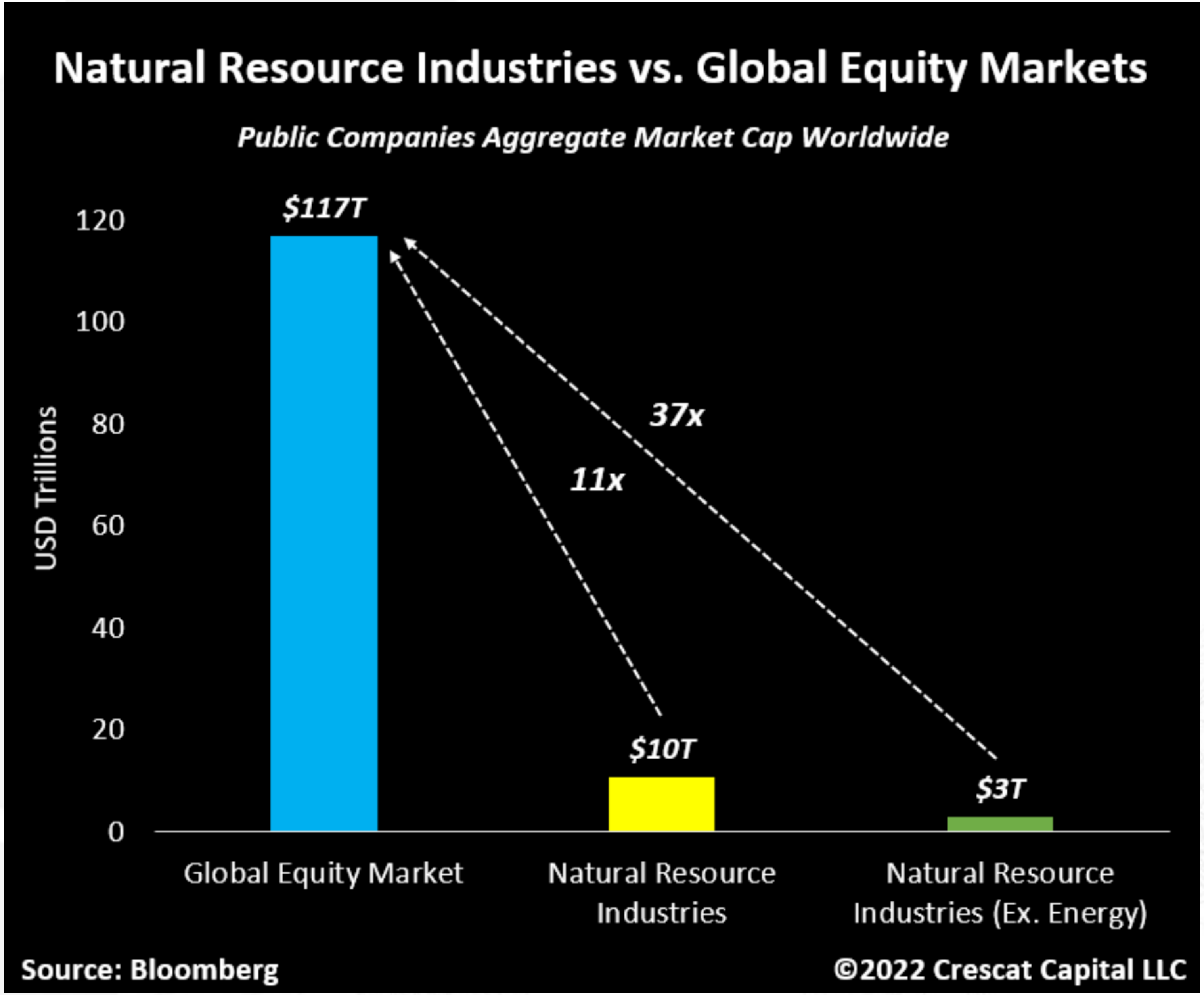
RESOURCE UNDERINVESTMENT

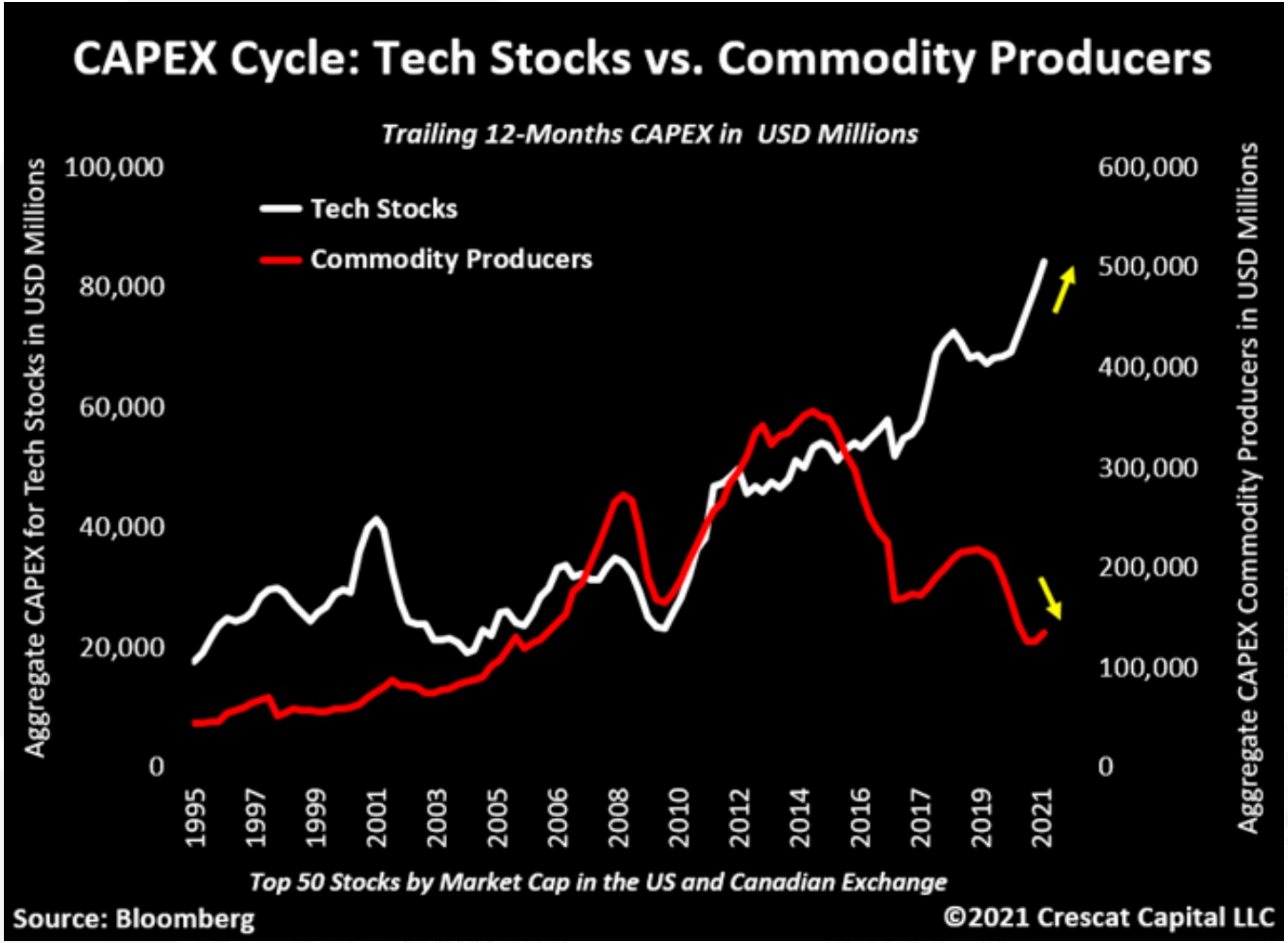


This white line is very likely headed higher and should be one of the main investment cases for the long-term commodities bull market that we have just entered.



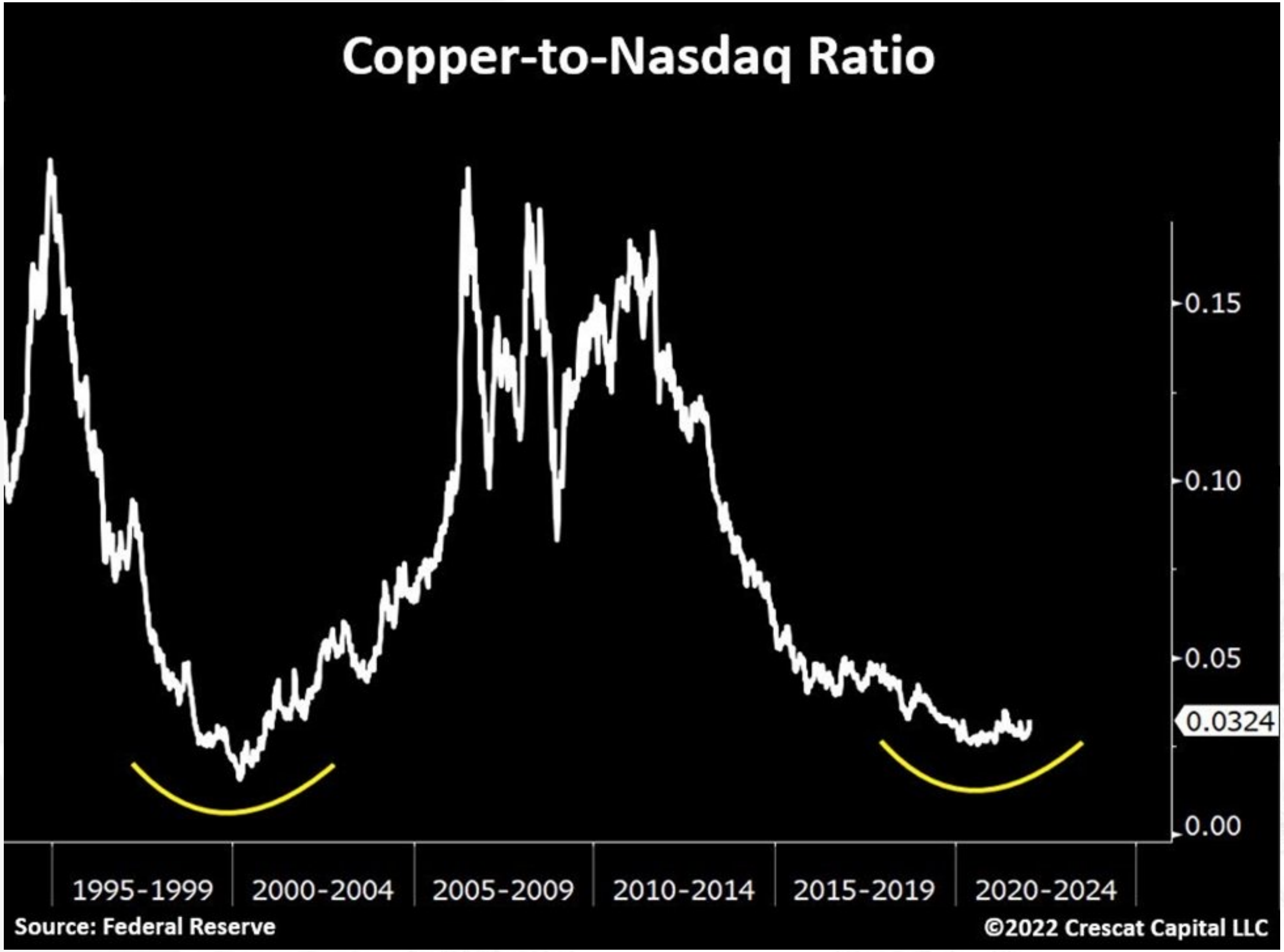
The aggregate market cap for global equity markets is 11x larger than the current size of natural resource industries.

If we exclude the energy sector, it is close to 37x.

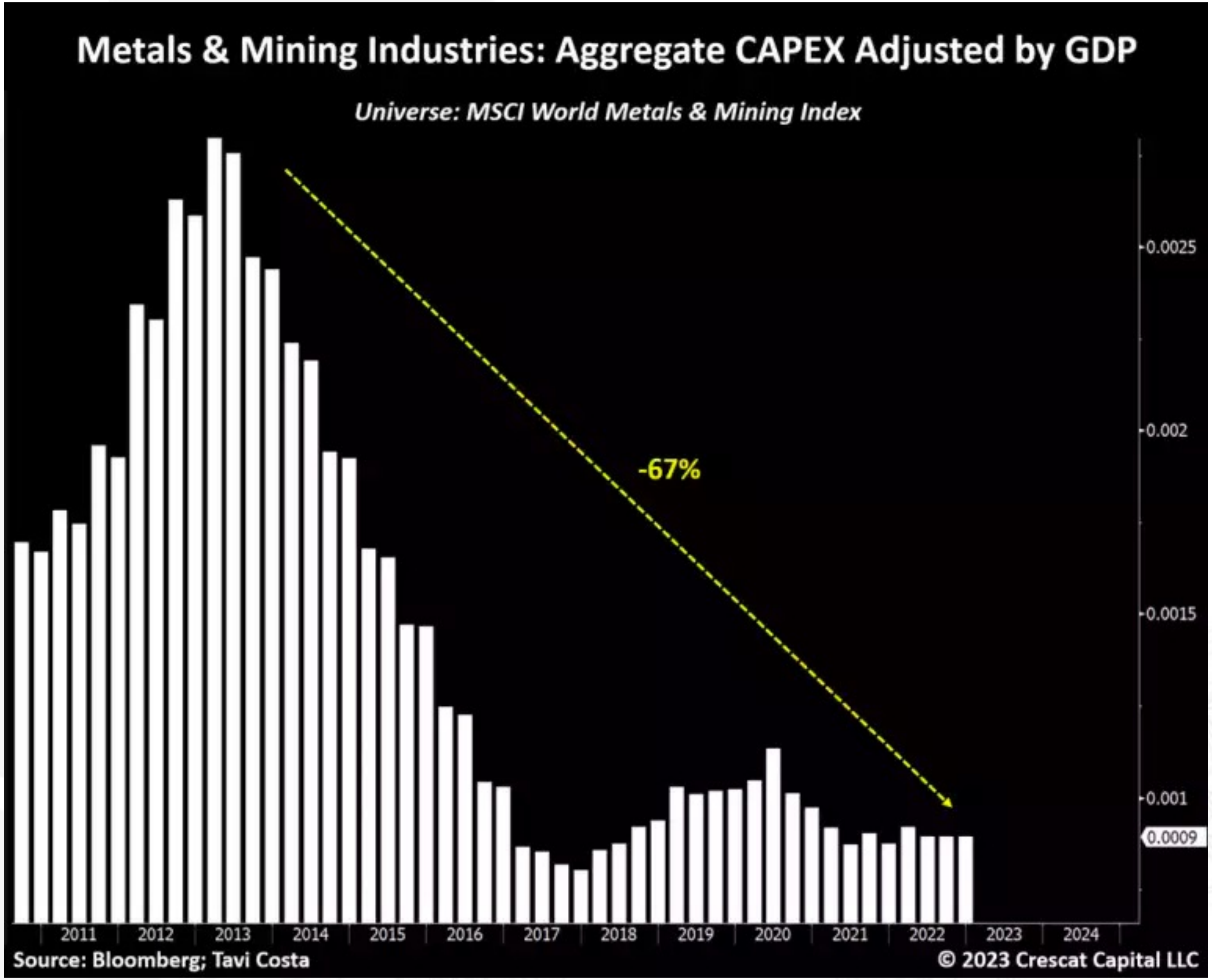


There has been a major divergence between the long-term capex of technology companies versus commodity producers.

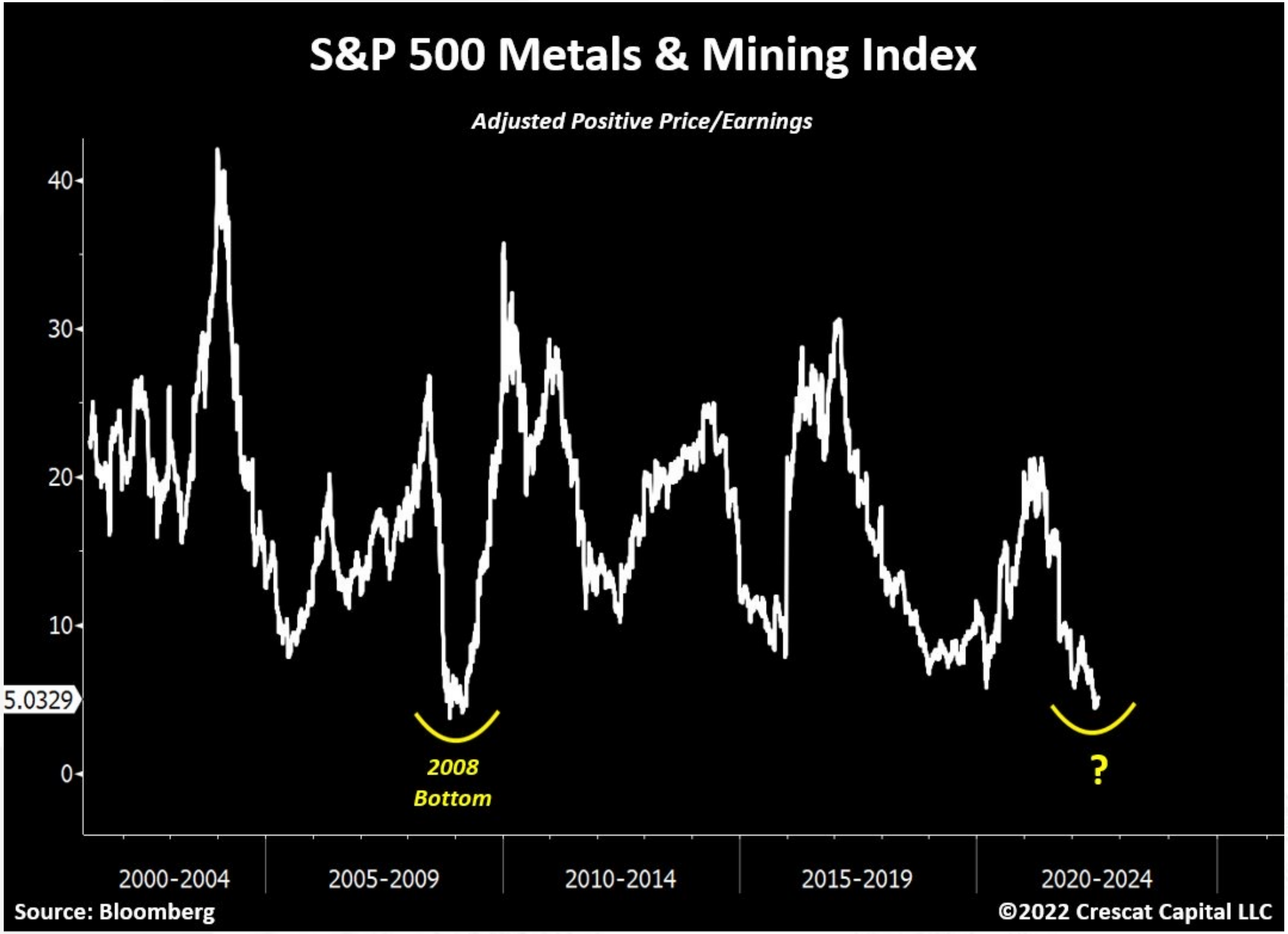
This disconnection began in 2015, long before the Covid Recession.



The copper-to-Nasdaq ratio is currently re-testing the early-2000s lows.



This worldwide index of metals and mining companies also shows a nearly 70% decline in capital spending from 2013 levels.



The case for owning mining companies has never been more compelling.

While we have seen general fundamental improvements across the industry, today's profitable mining companies are also trading at their lowest-ever P/E ratio, one that is currently matching their 2008 bottom.

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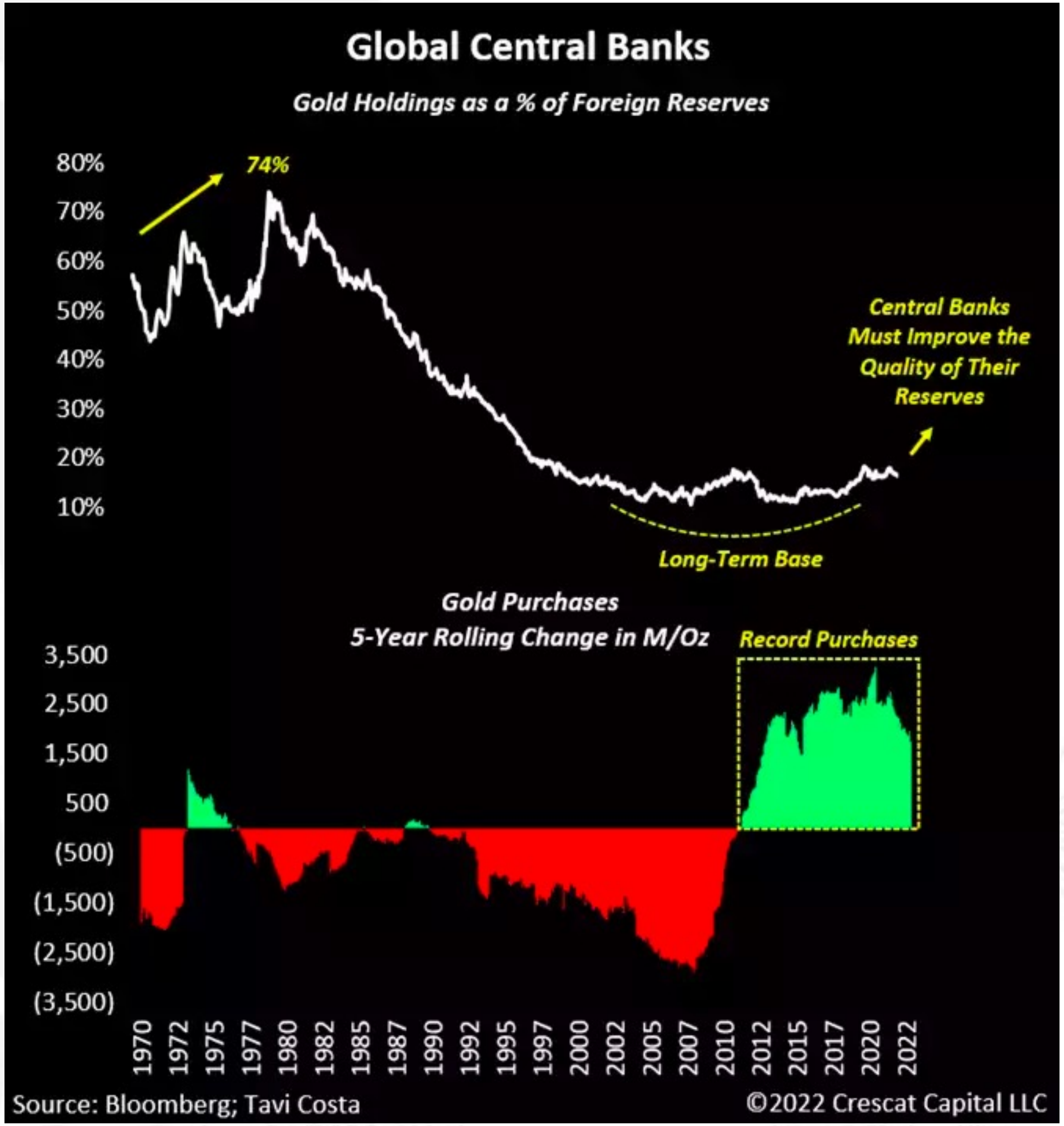
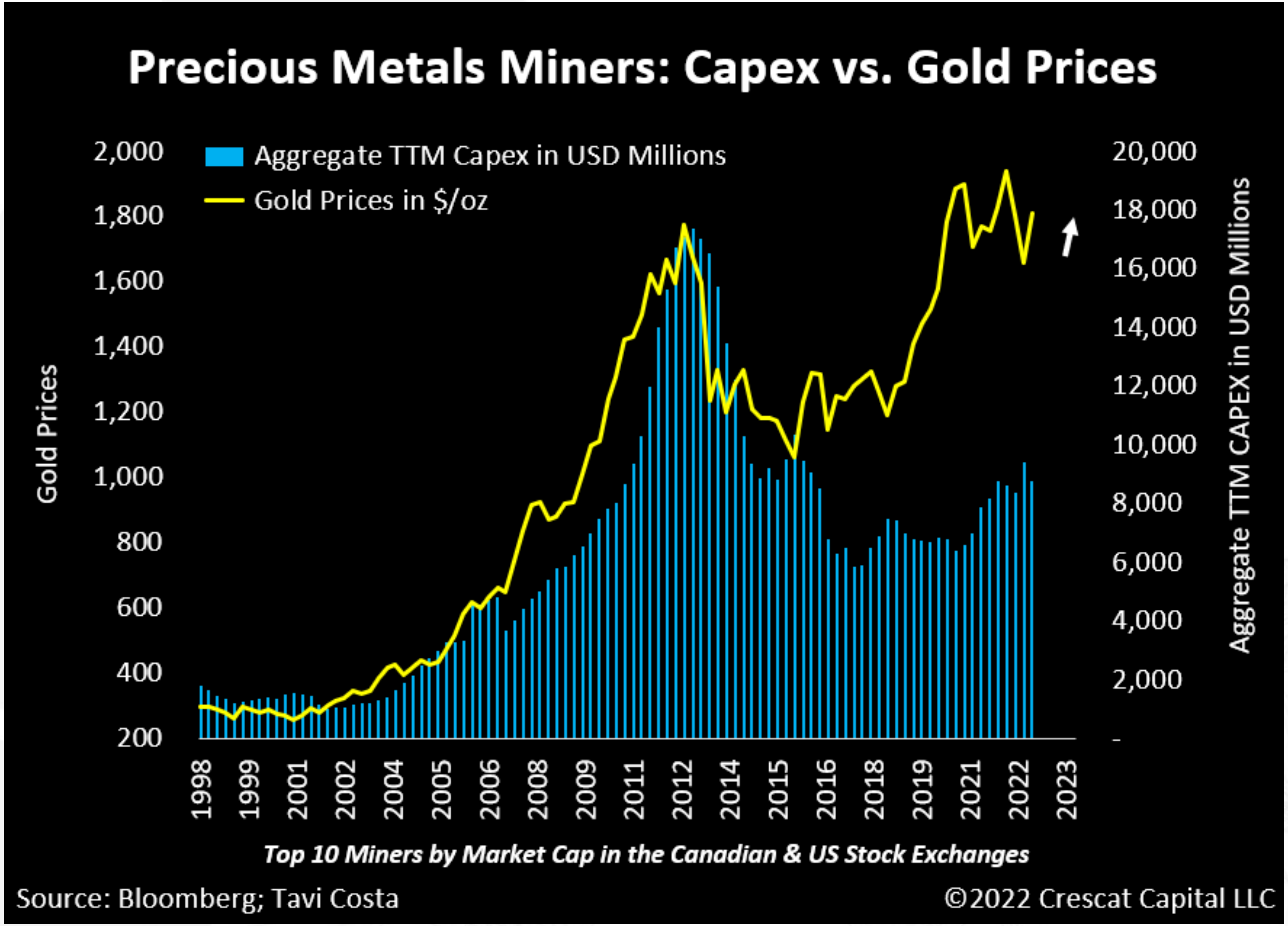
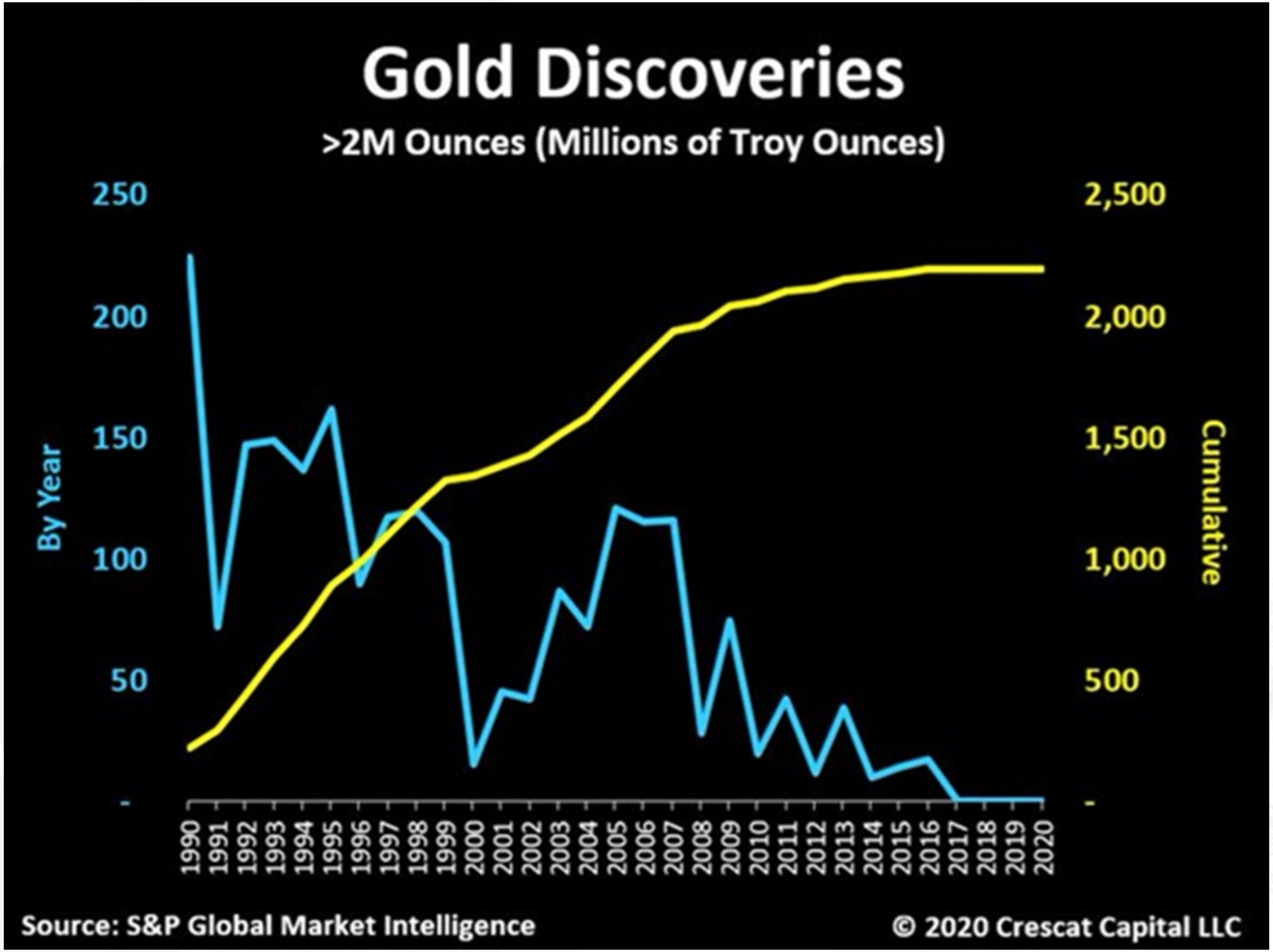


This is setting the stage for gold to reemerge as a key asset in improving the credibility of central banks' balance sheets. Rising geopolitical tensions only add to this thesis with gold being the perfect neutral alternative.

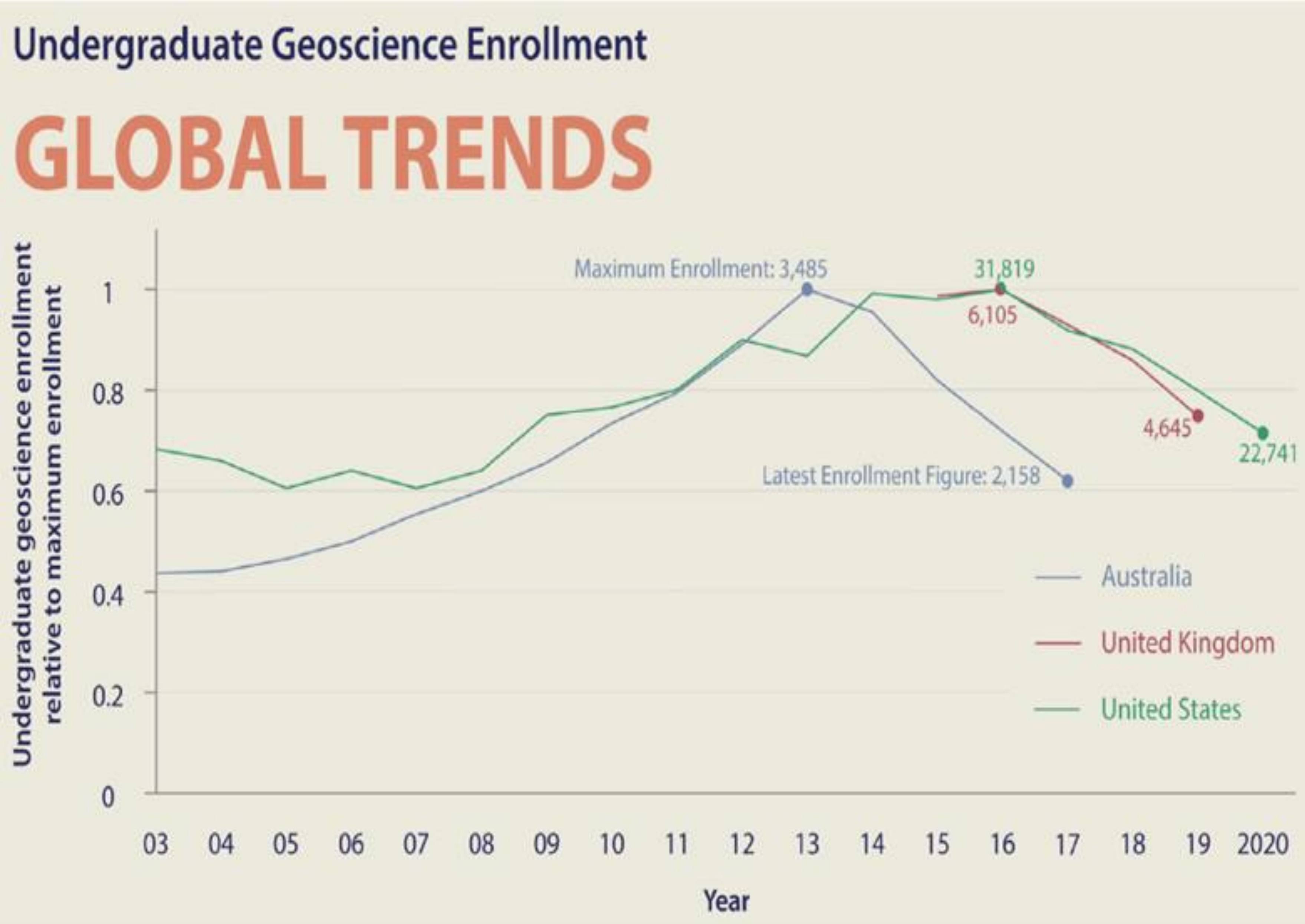


Today, while gold is currently near its 2011 highs, aggregate capital spending for the miners remains at historically depressed levels.

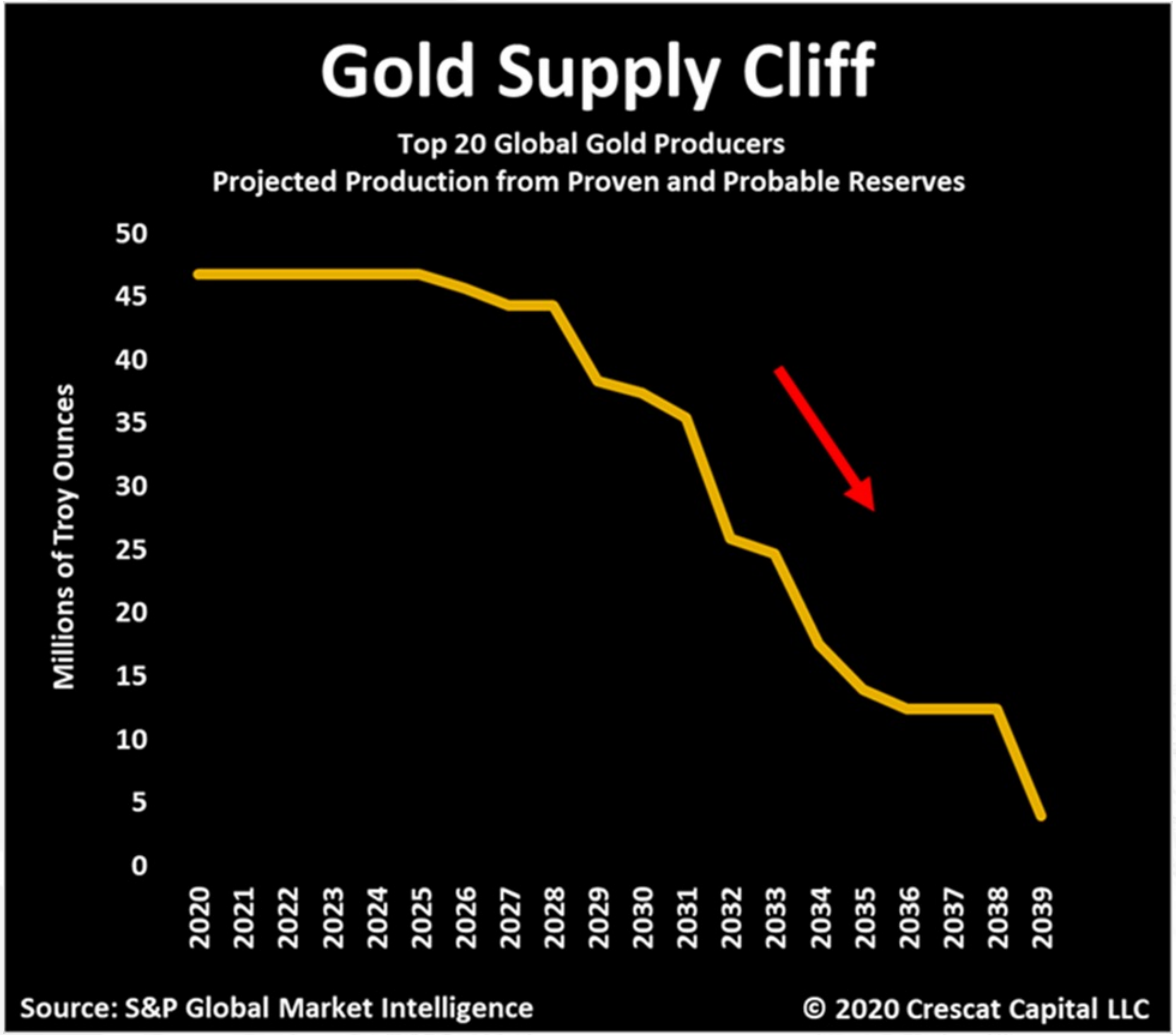
This goes to show again how management teams are excessively conservative despite a firming gold market.



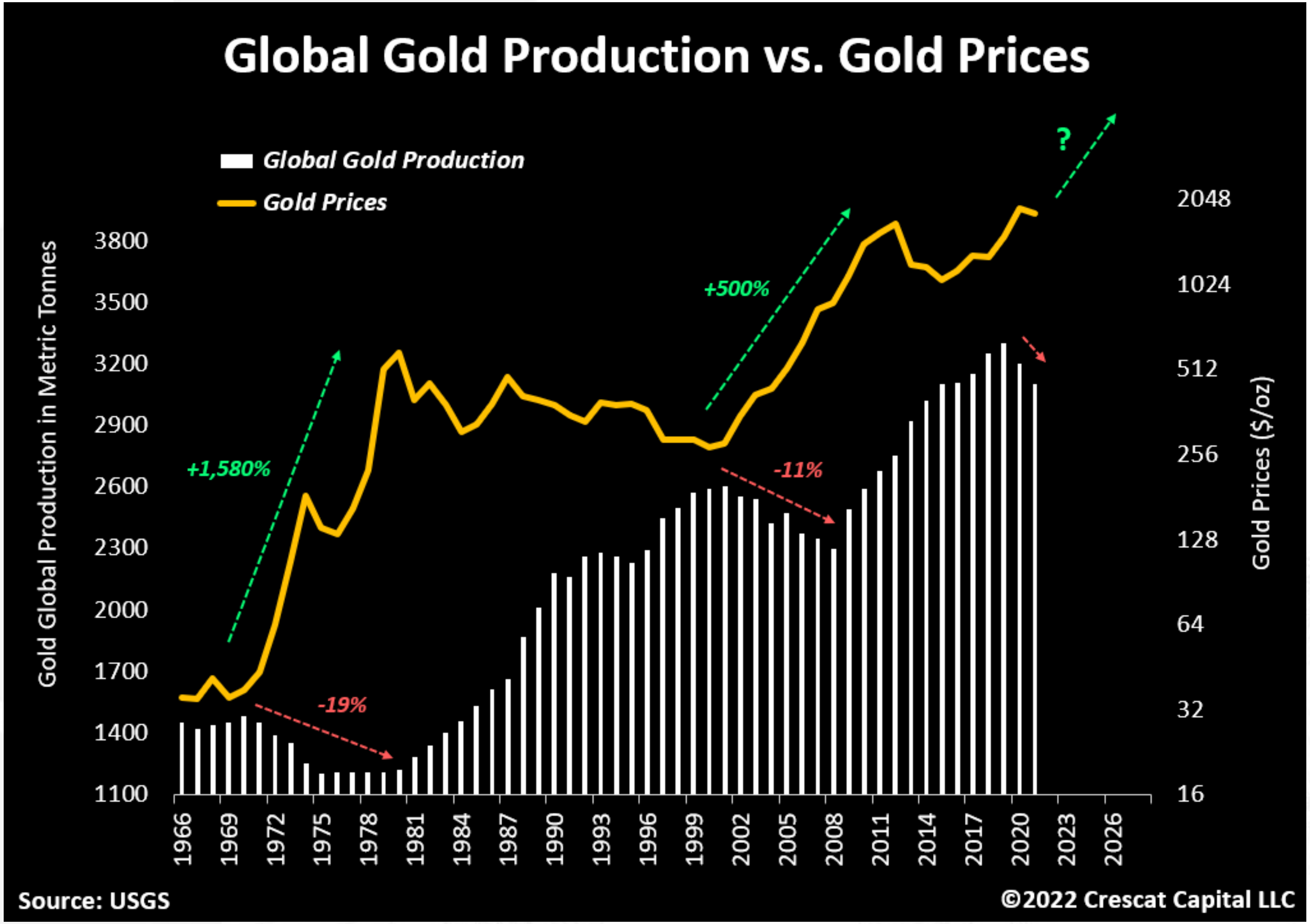
Contributing to the supply shortage, the number of major new gold discoveries by year, i.e., greater than 2 million Troy ounces, has been in a declining secular trend for 30 years including the cyclical boost between 2000 and 2007.



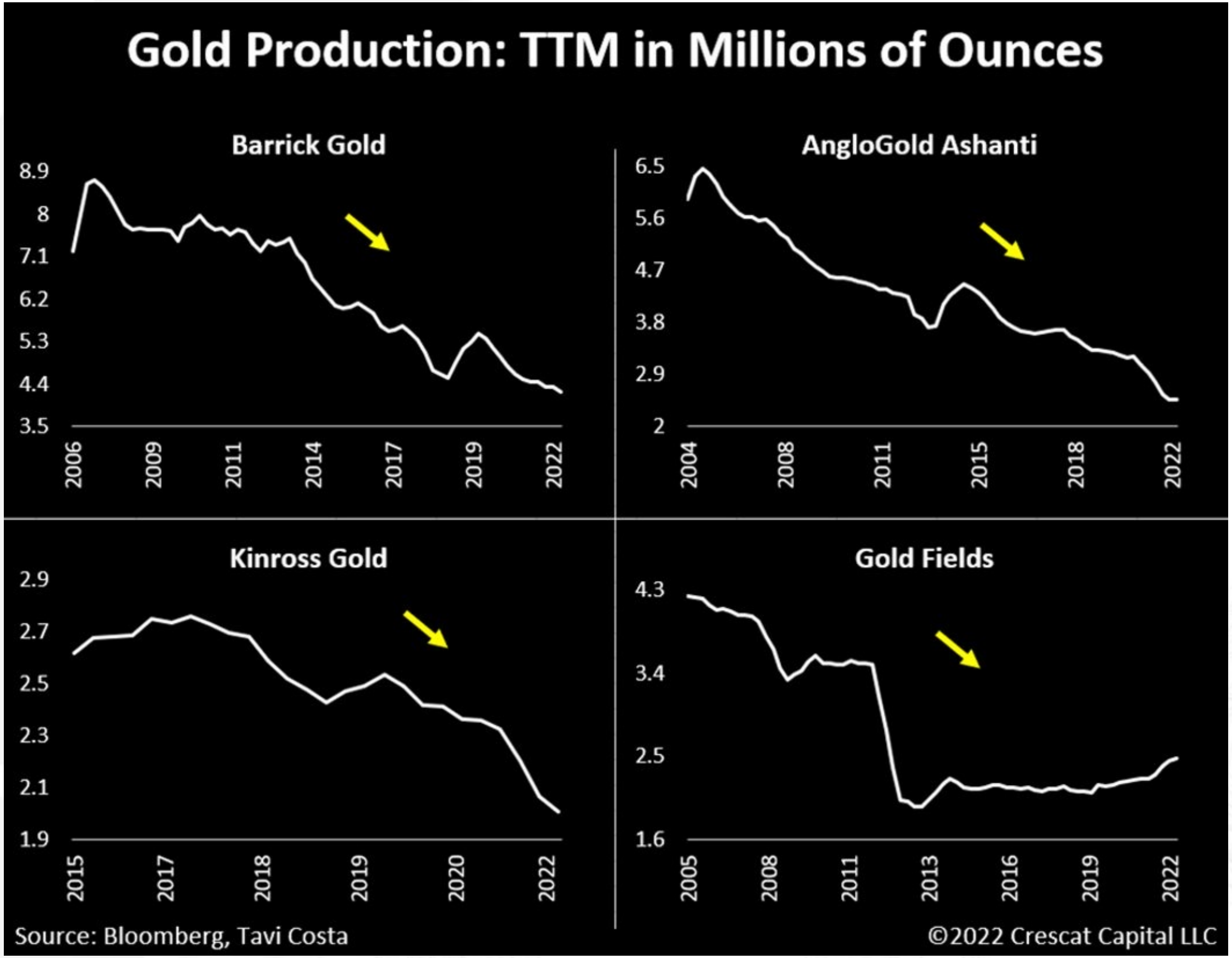
While demand continues to increase for the raw materials produced by these industries, companies are having difficulty filling jobs with qualified management and technical professionals to produce them efficiently. A decade of declining college enrollment in geosciences worldwide is one of the long-term structural imbalances affecting the oil and gas and mining industries.



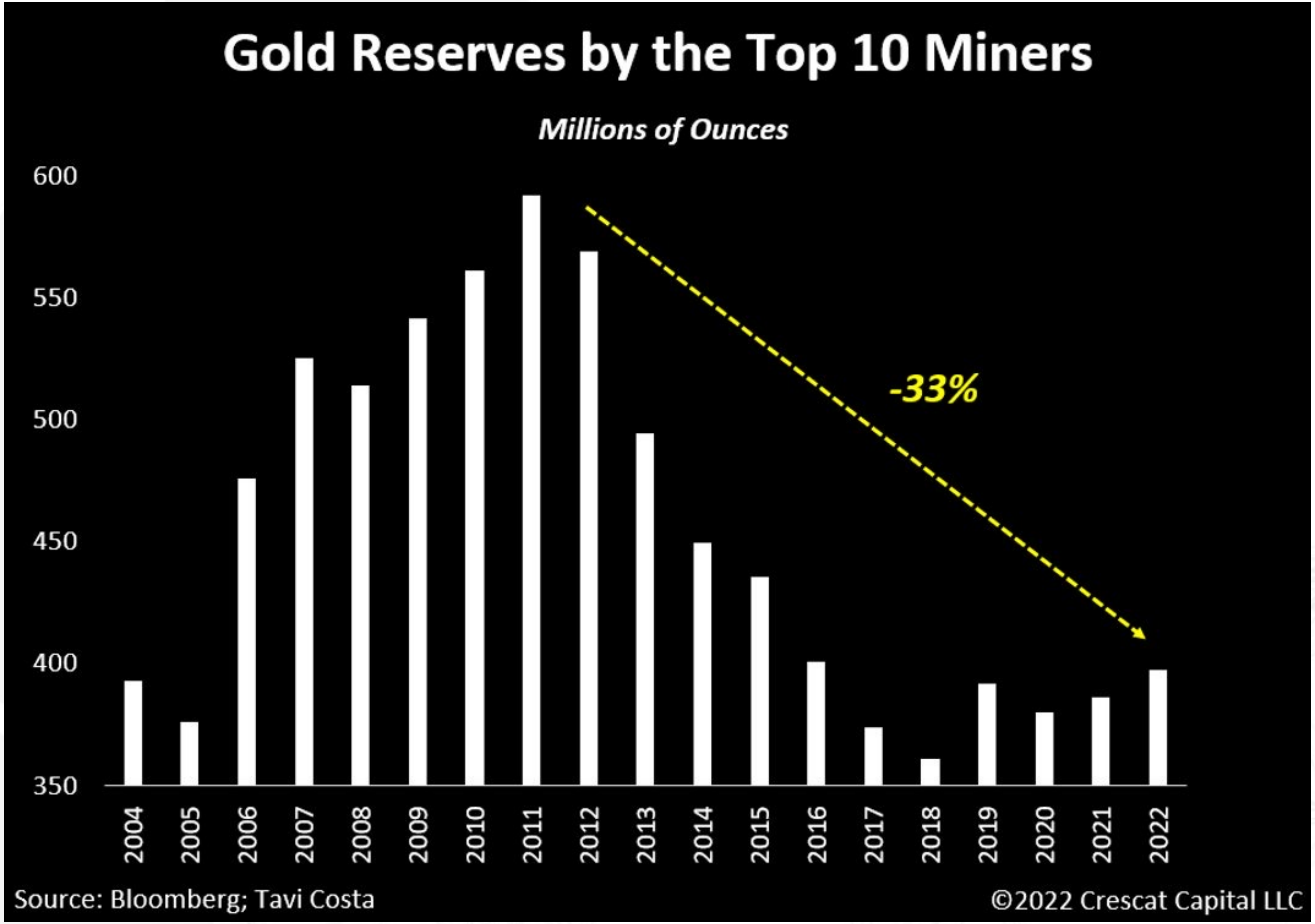
Major miners are now facing a gold supply cliff due to a chronic period of under investments in the industry.



The scarce metal is supplanting US Treasuries as the preferred allocation among global central banks looking to improve the quality of their international reserves.

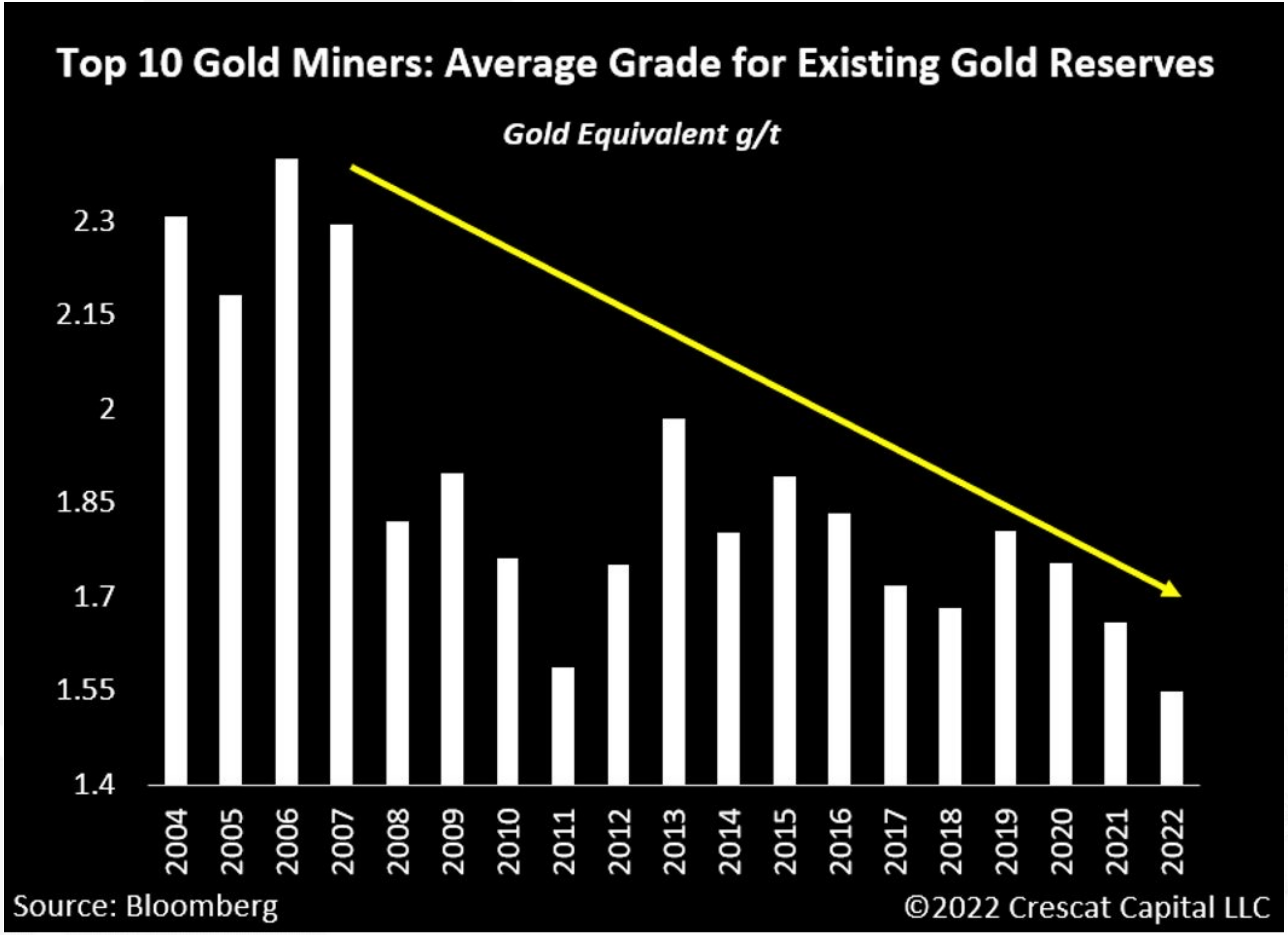


Many traditionally gold-focused miners have significantly shrunk their production while increasing investment in other metals.



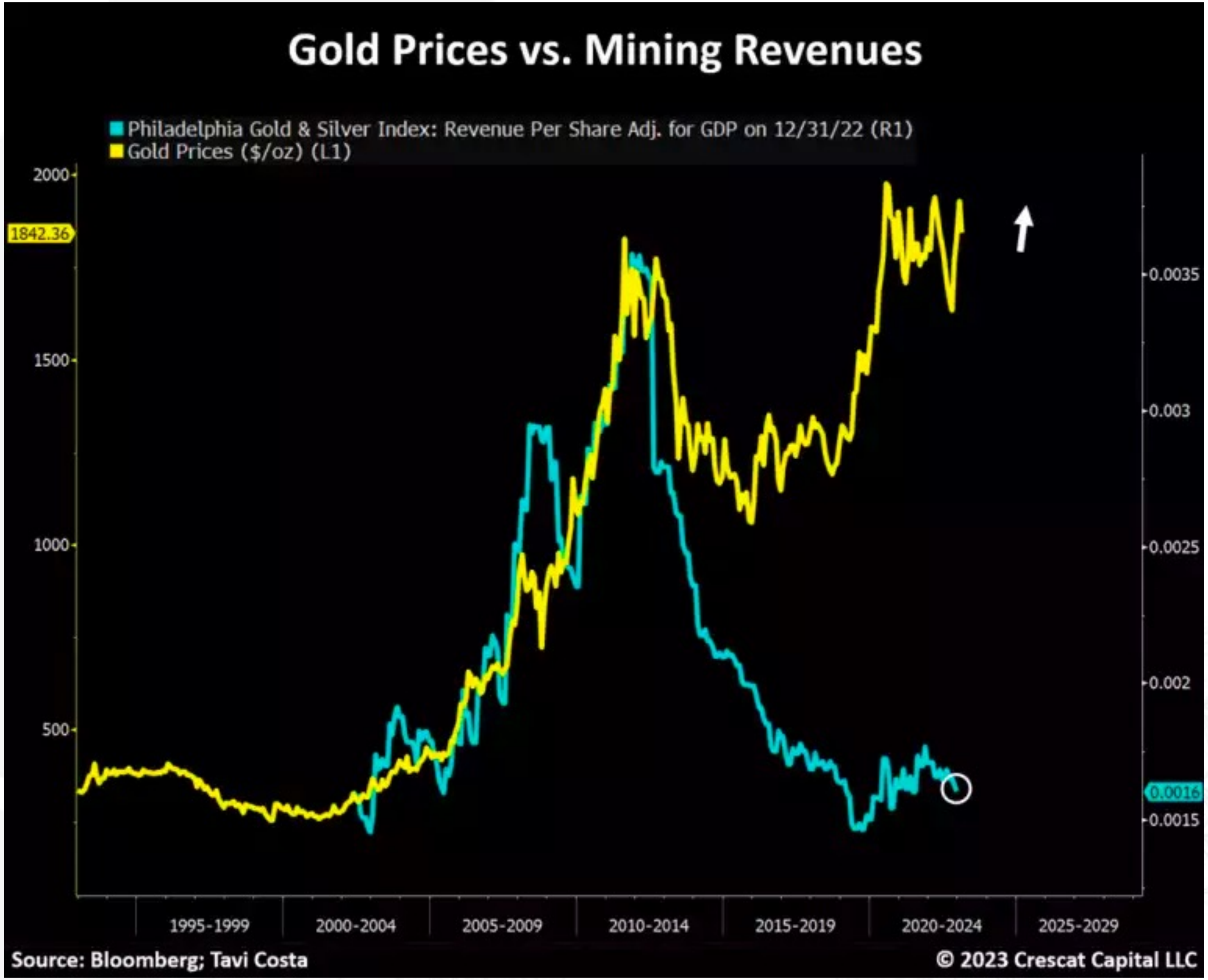
It is becoming increasingly challenging to find precious metals. As a result, the reserves of the top 10 mining companies are down 33% over the last 15 years.

We have not seen a new precious metals project become a significant producing mine in a very long time.

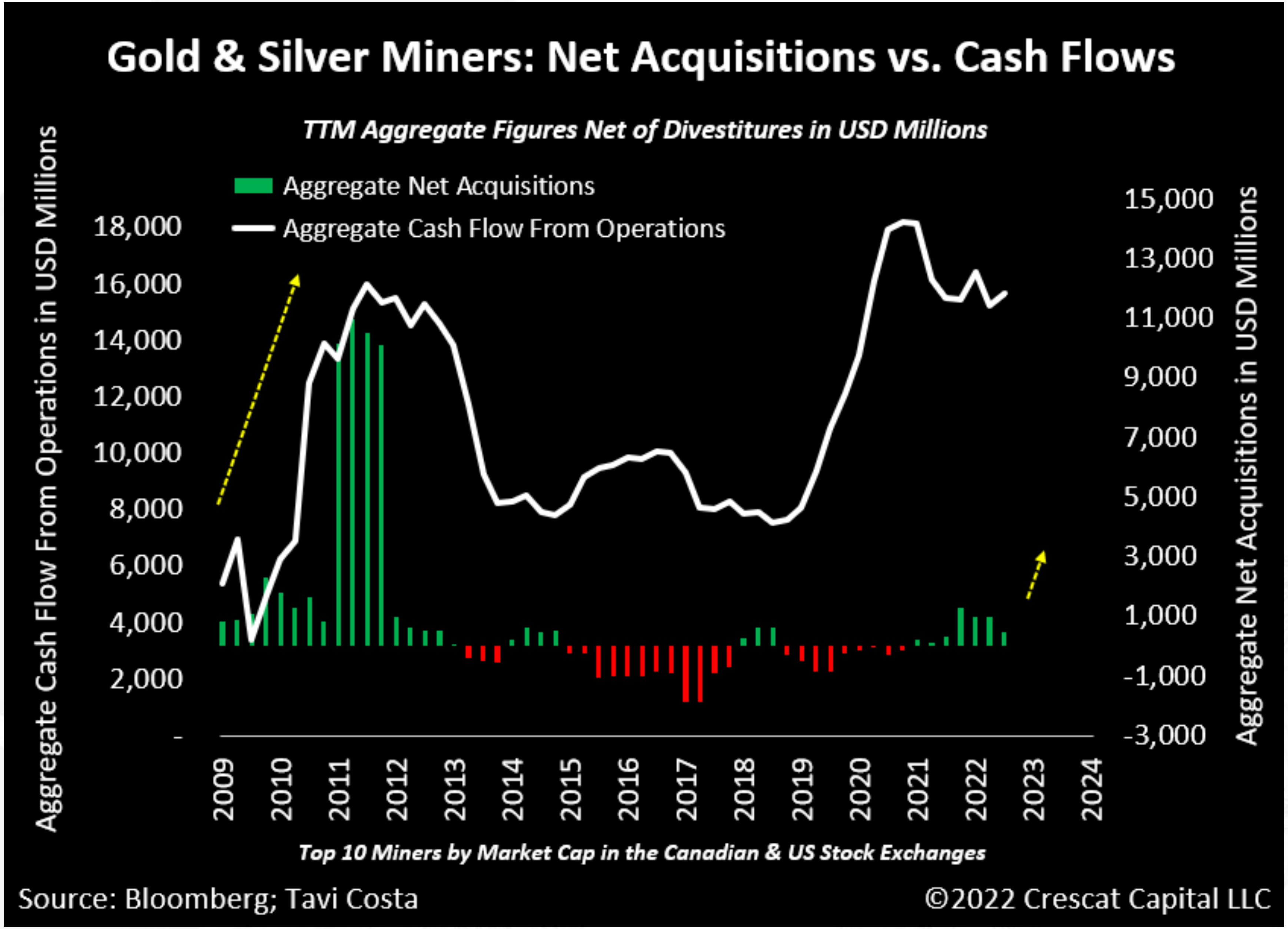


Not only do mining companies continue to deplete their existing reserves, but the quality of their remaining assets is drastically deteriorating.

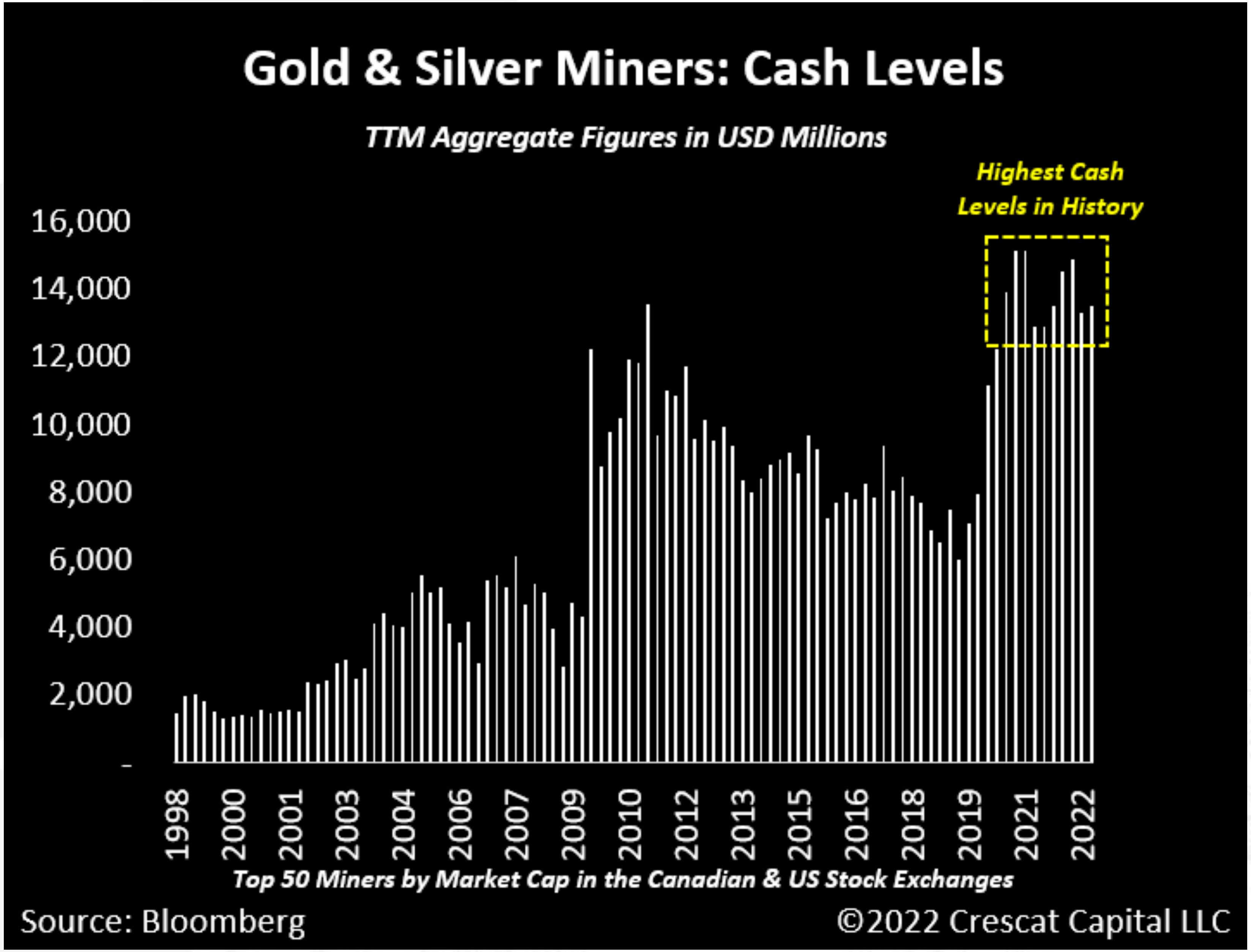
The average grade for gold reserves by the top 10 miners in the world has been in a secular decline.



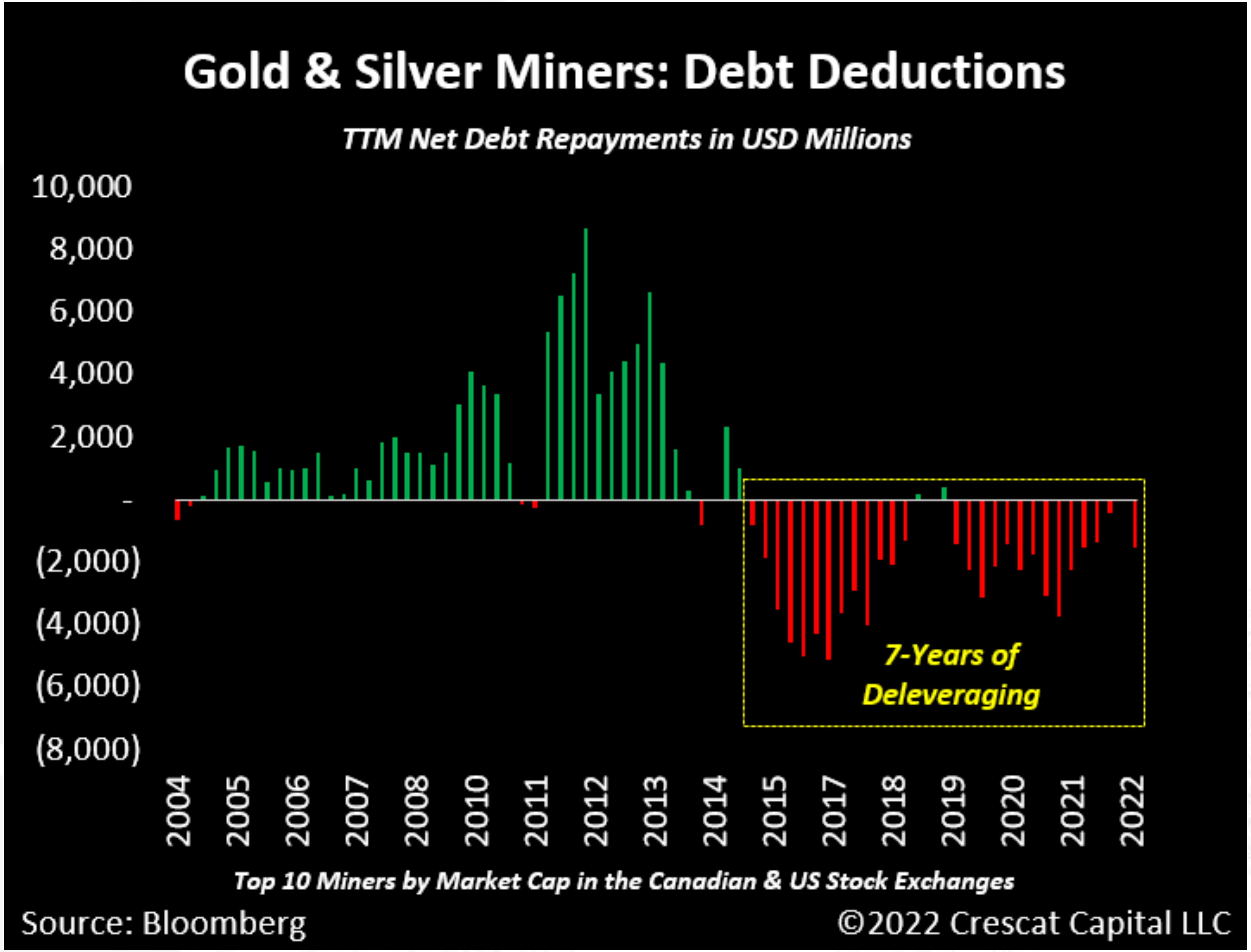
The large and mid-tier mining companies have underinvested in exploration as well as M&A, so both the quantity and quality of their reserves have deteriorated over the last decade.



It is important to note how miners continue to generate near-record levels of cash flows today.

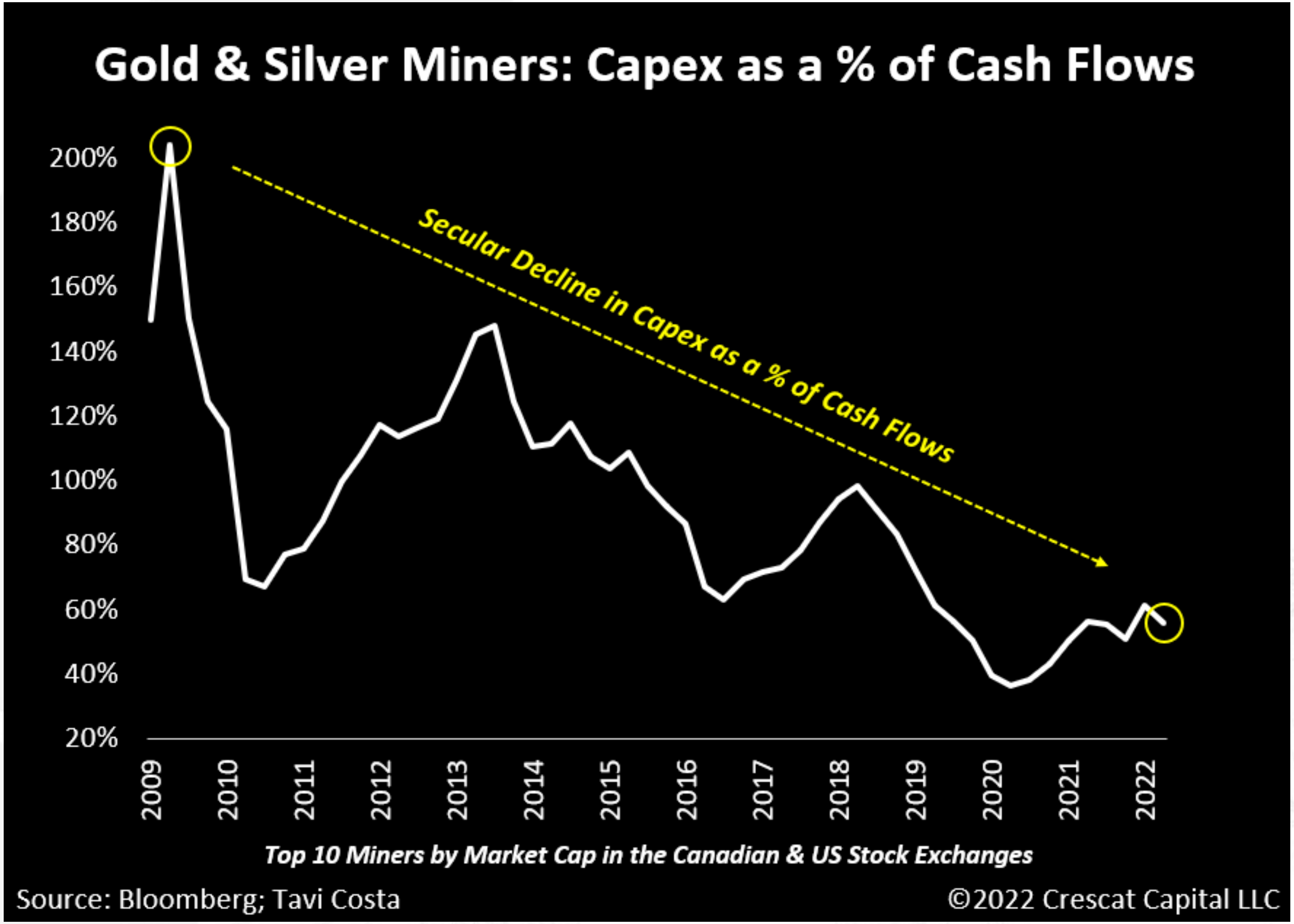


The strength of the balance sheets of mining companies is an important factor that tends to precede healthy M&A cycles. As shown in the chart below, the largest gold and silver companies have the highest cash levels that we have seen in decades.

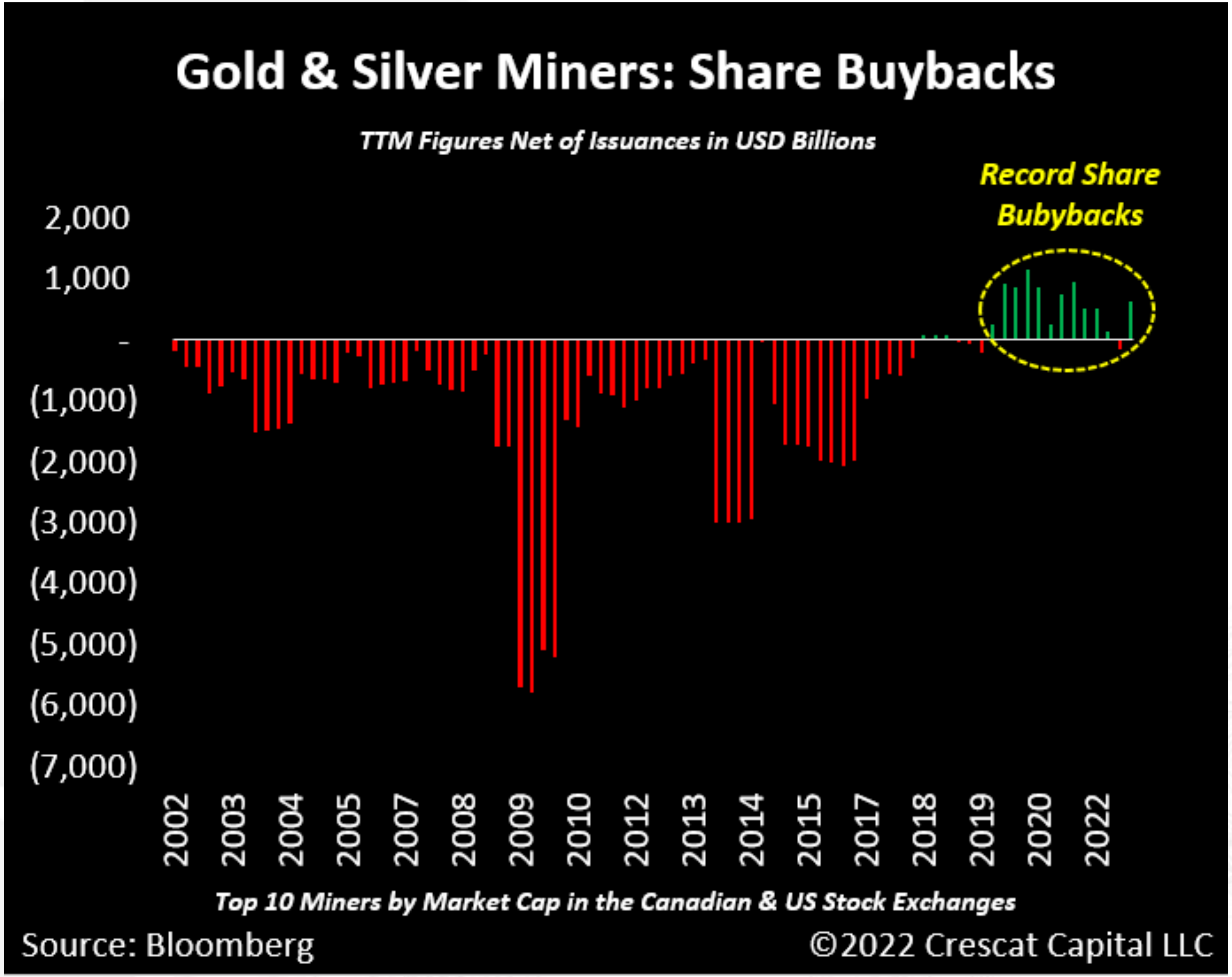


Precious metals mining companies just went through a long deleveraging process.

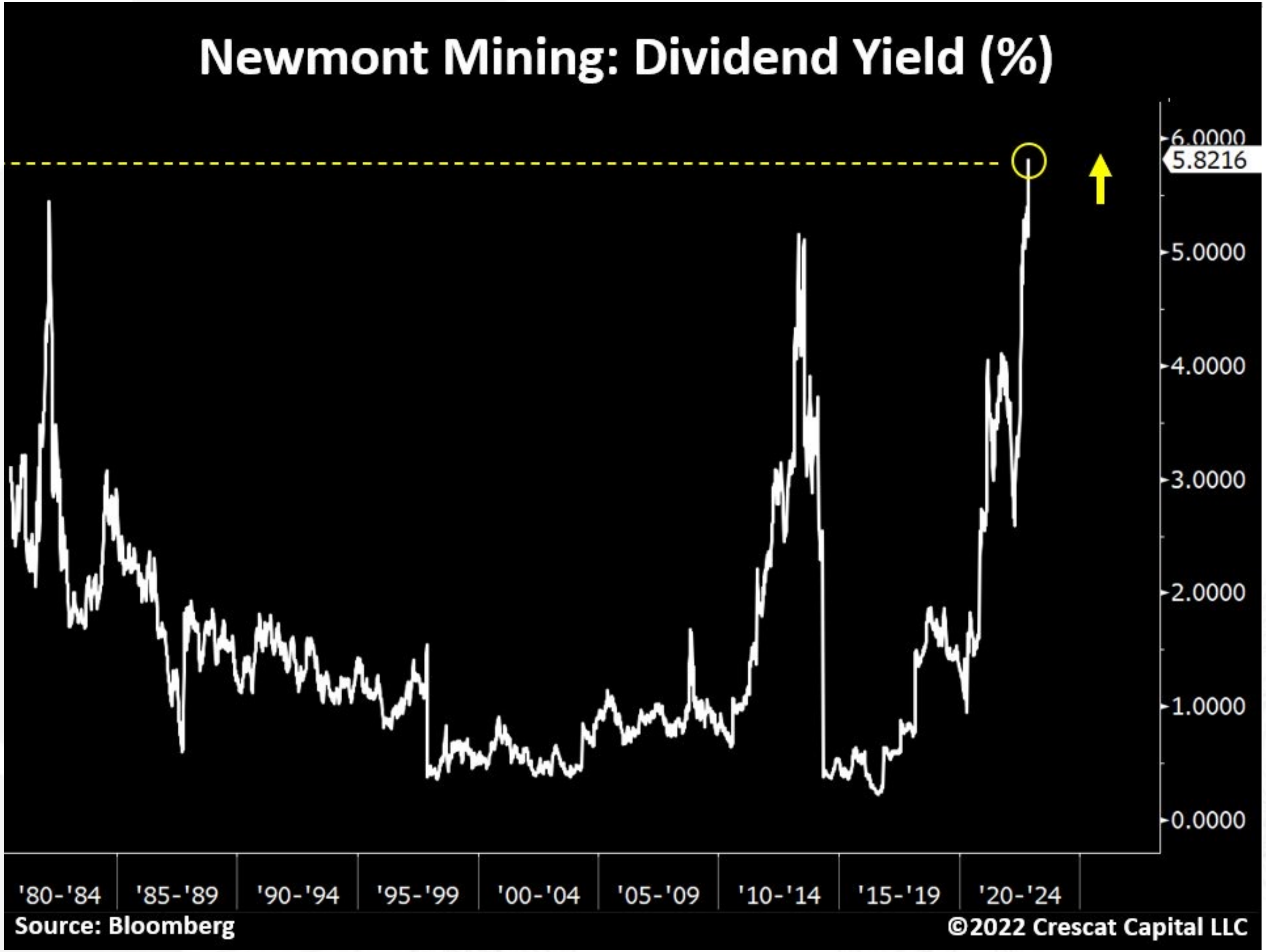
In other words, the industry had seven years of continuous debt repayment, net of new issuances. This is a very healthy development for miners overall.



These stocks can still be acquired in the market today for cheap ahead of a new gold bull market.



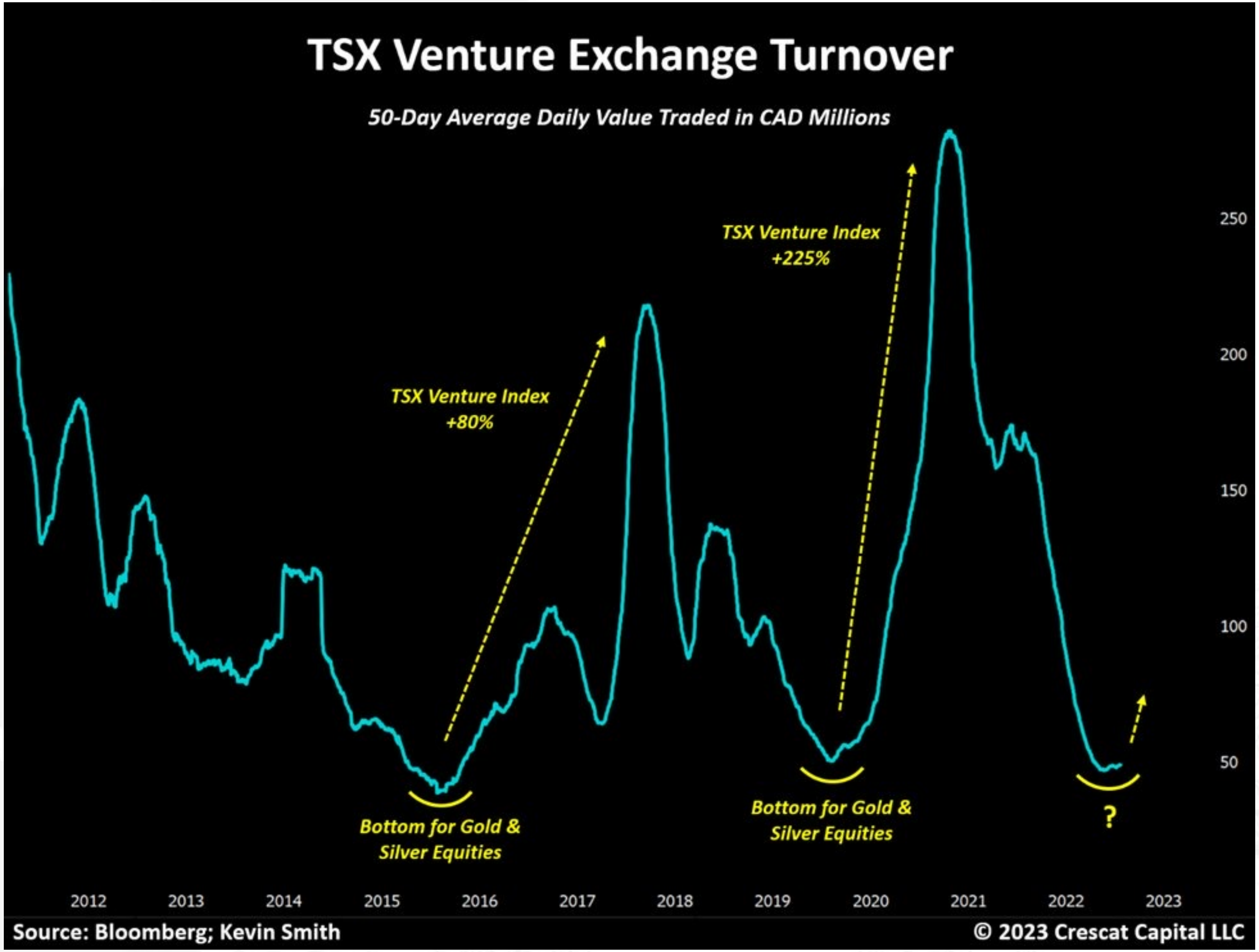
These companies are going above and beyond to attract investors with accounting conservatism rather than investing for growth.



Newmont has increased its dividend in six of the last nine quarters and the stock now has the highest yield in 40 years.

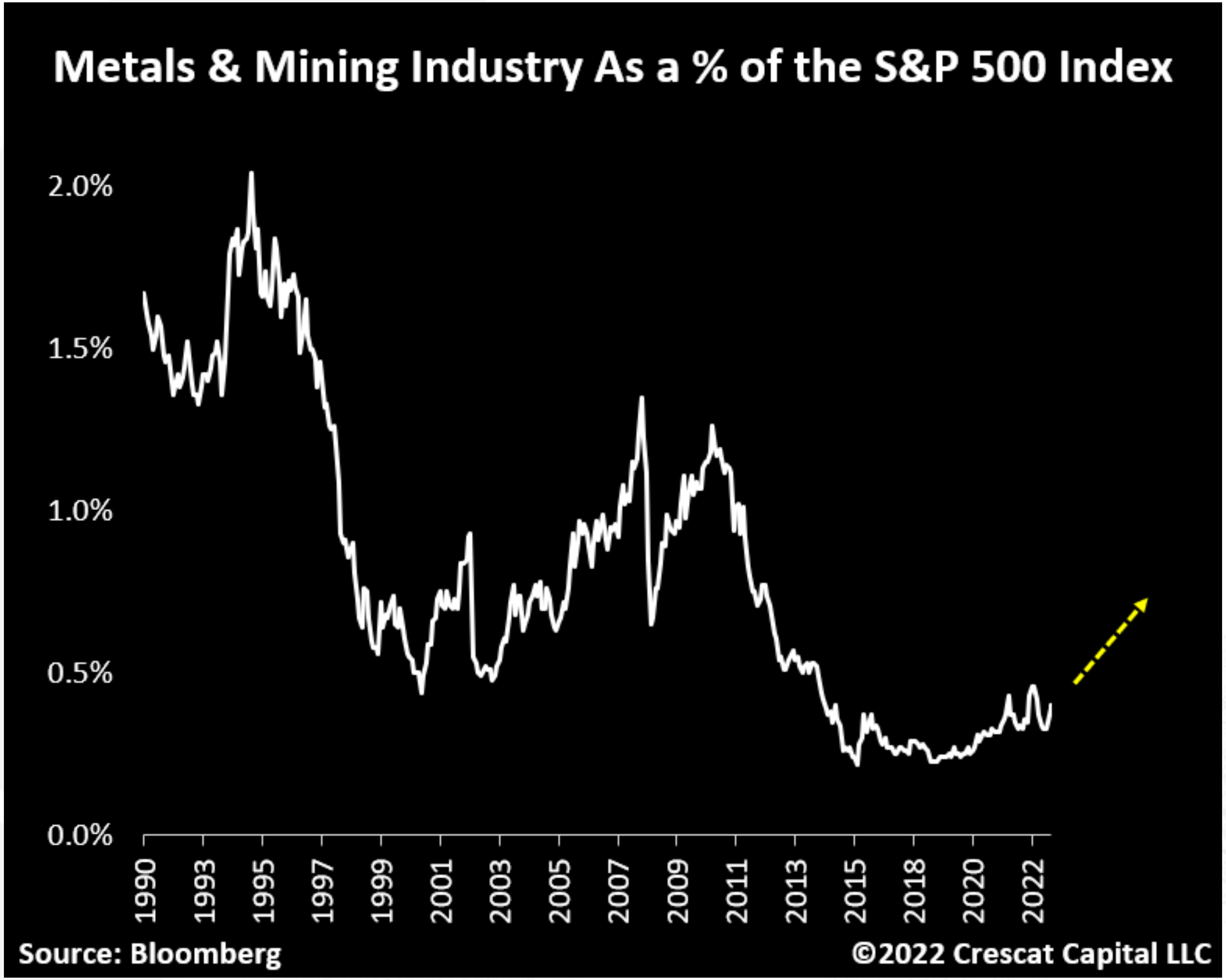
Precious metals mining is one of the most fundamentally attractive industry groups in the market today. Interestingly, the gold price is almost back to its 2011 monthly highs.

If that is the playbook for the miners, there is 85% upside from here.



The turnover volume for smaller mining companies remains incredibly depressed.

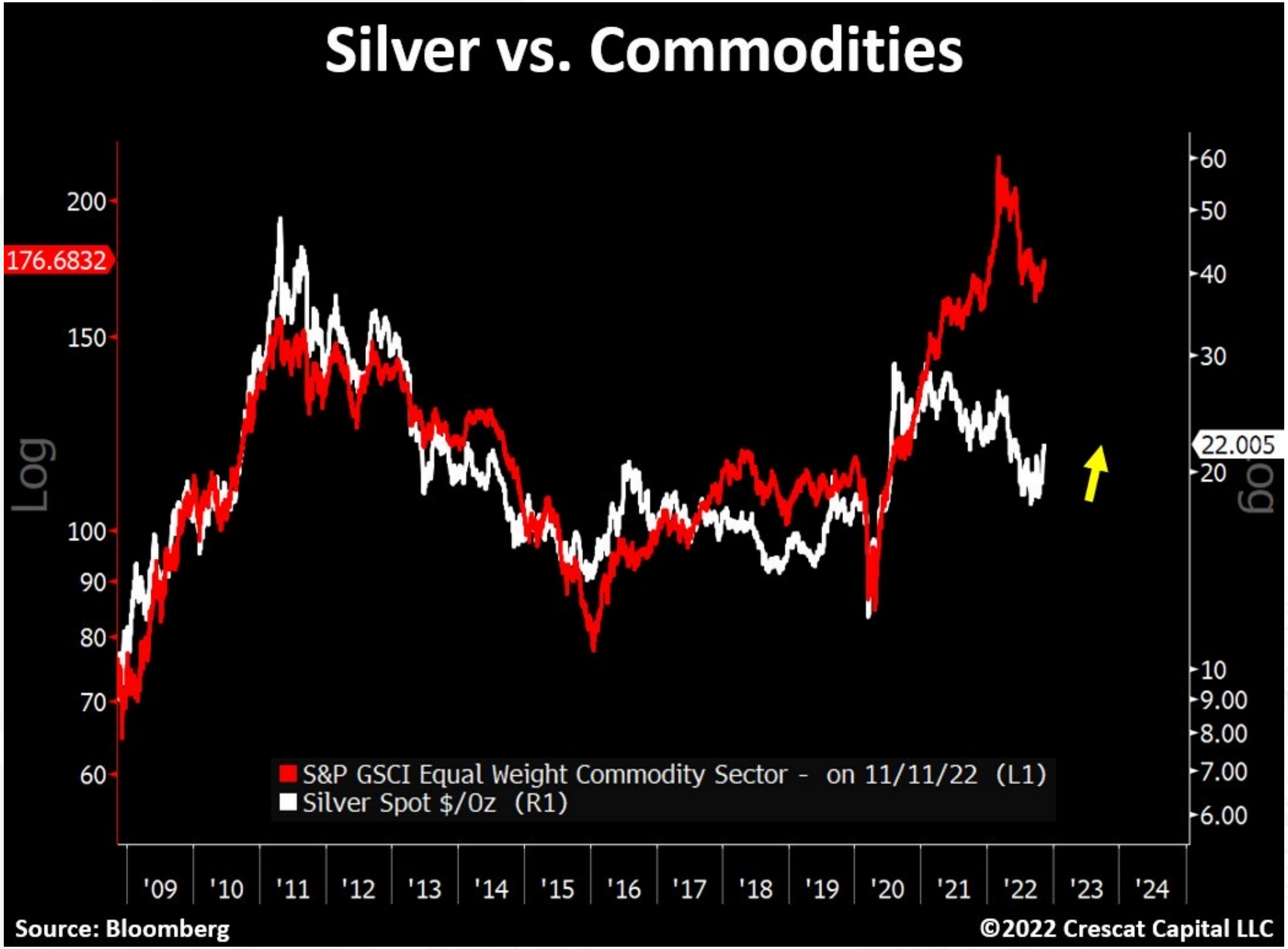
The 50-day average traded volume in the TSX Venture Exchange is currently re-testing its prior historical lows.



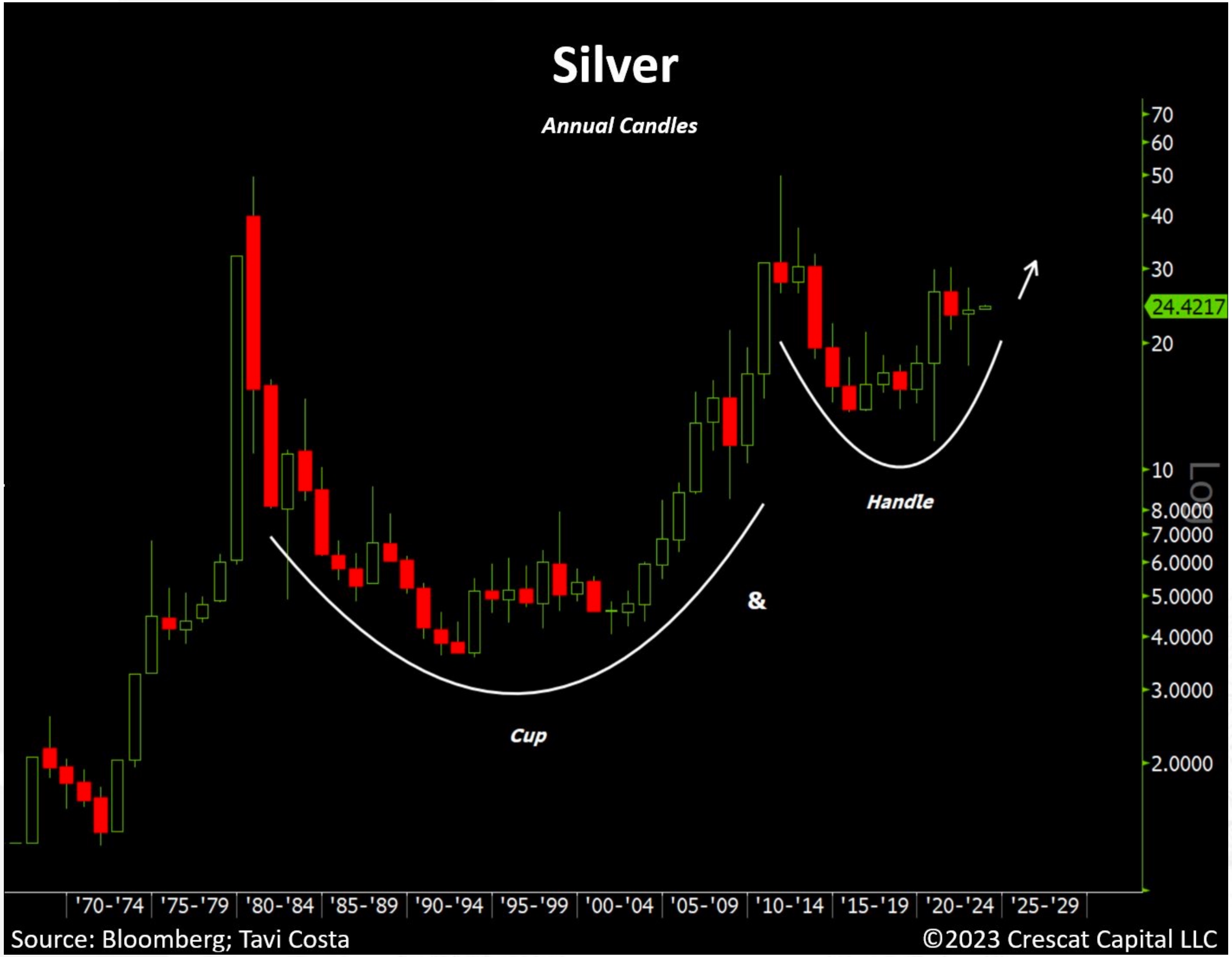
The metals and mining industry as part of the overall stock market is almost a rounding error.

We believe this chart will look completely different by the end of this decade.

When looking at the silver relative to M2 money supply, it may have recently just reached a historic double-bottom after re-testing the early 2000s levels, which preceded a major upward move in silver prices.

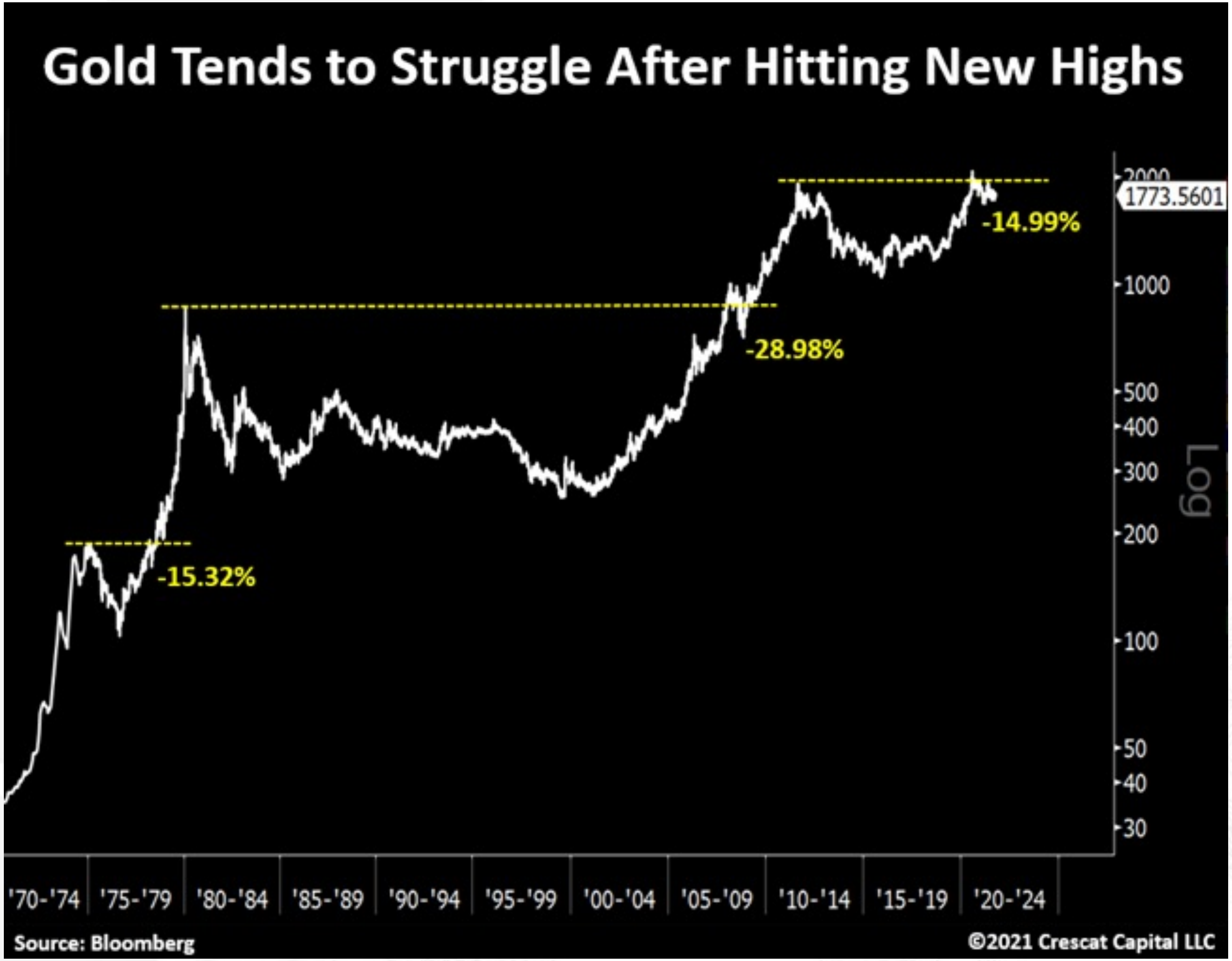


Silver has significantly lagged behind other commodities since 2020.
We believe the metal is poised for a major catch-up.
After two years of frustrating investors, silver looks ripe for an explosive and sustainable move to the upside.



It's hard to find a better-looking chart than this one.

Time to get aggressive with gold, silver, and the miners.



Gold prices tend to struggle after reaching new highs.

We have probably already seen most of this consolidation period.

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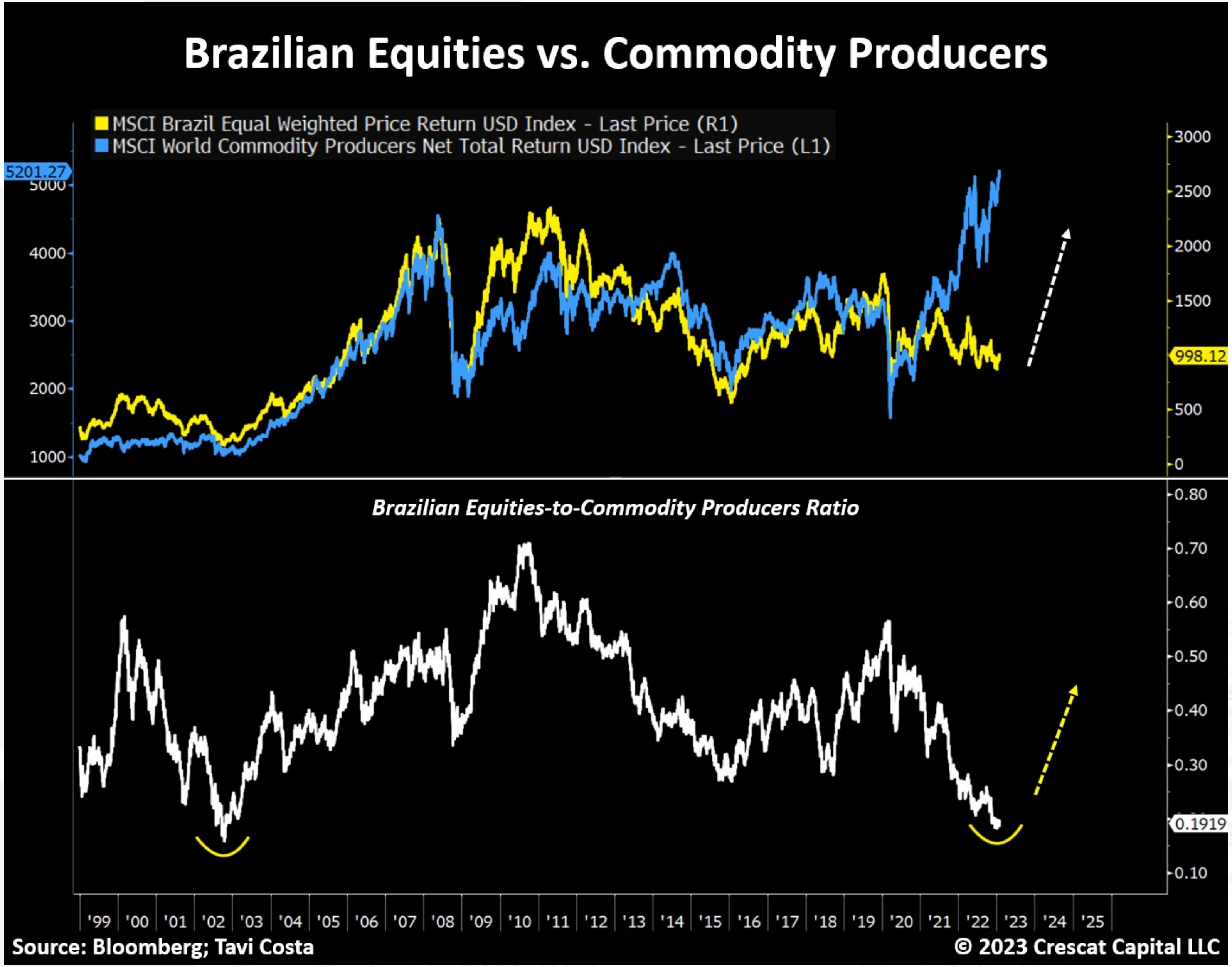
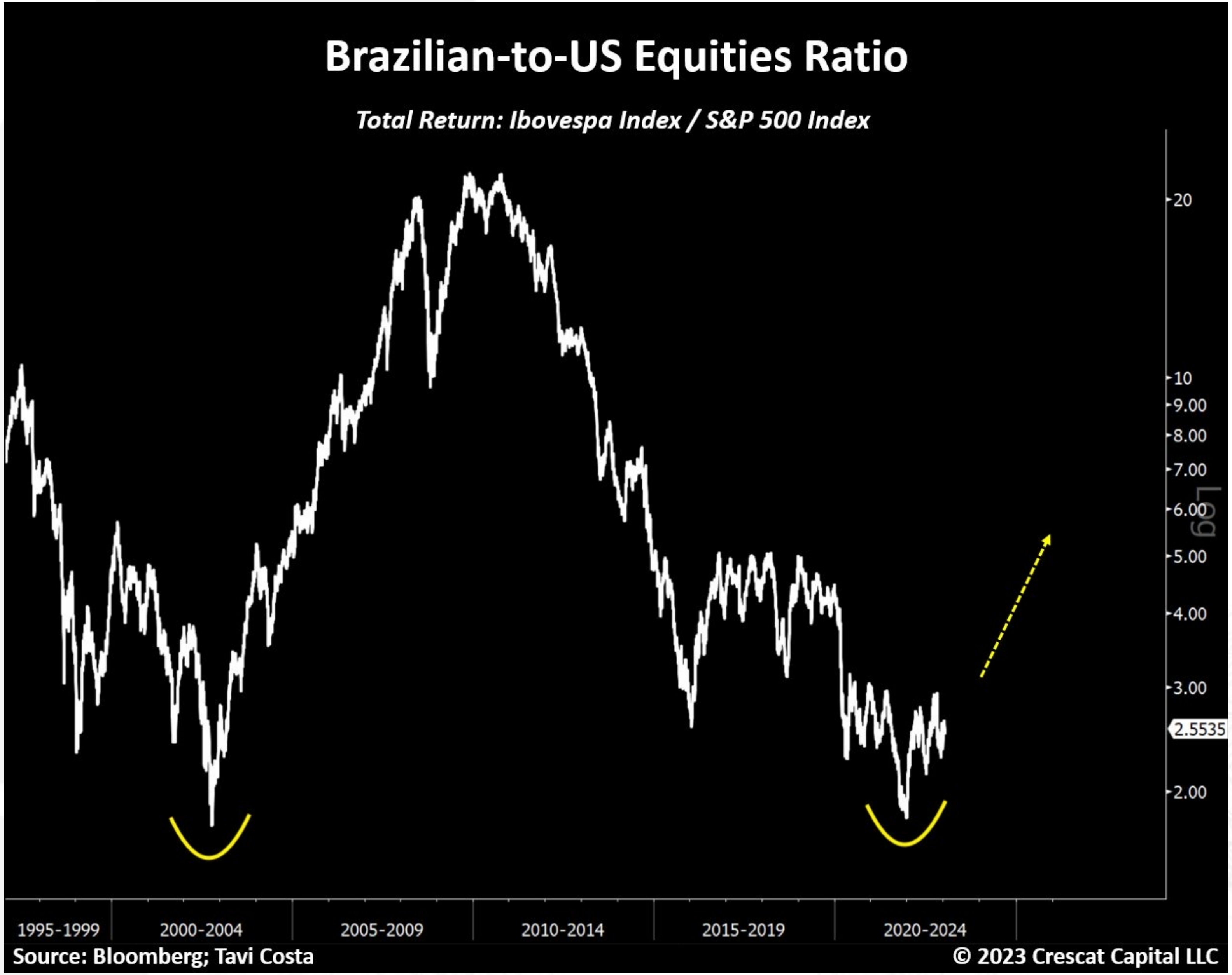
BRAZIL LIFTOFF



Brazilian equities are historically cheap even relative to global commodity producers.

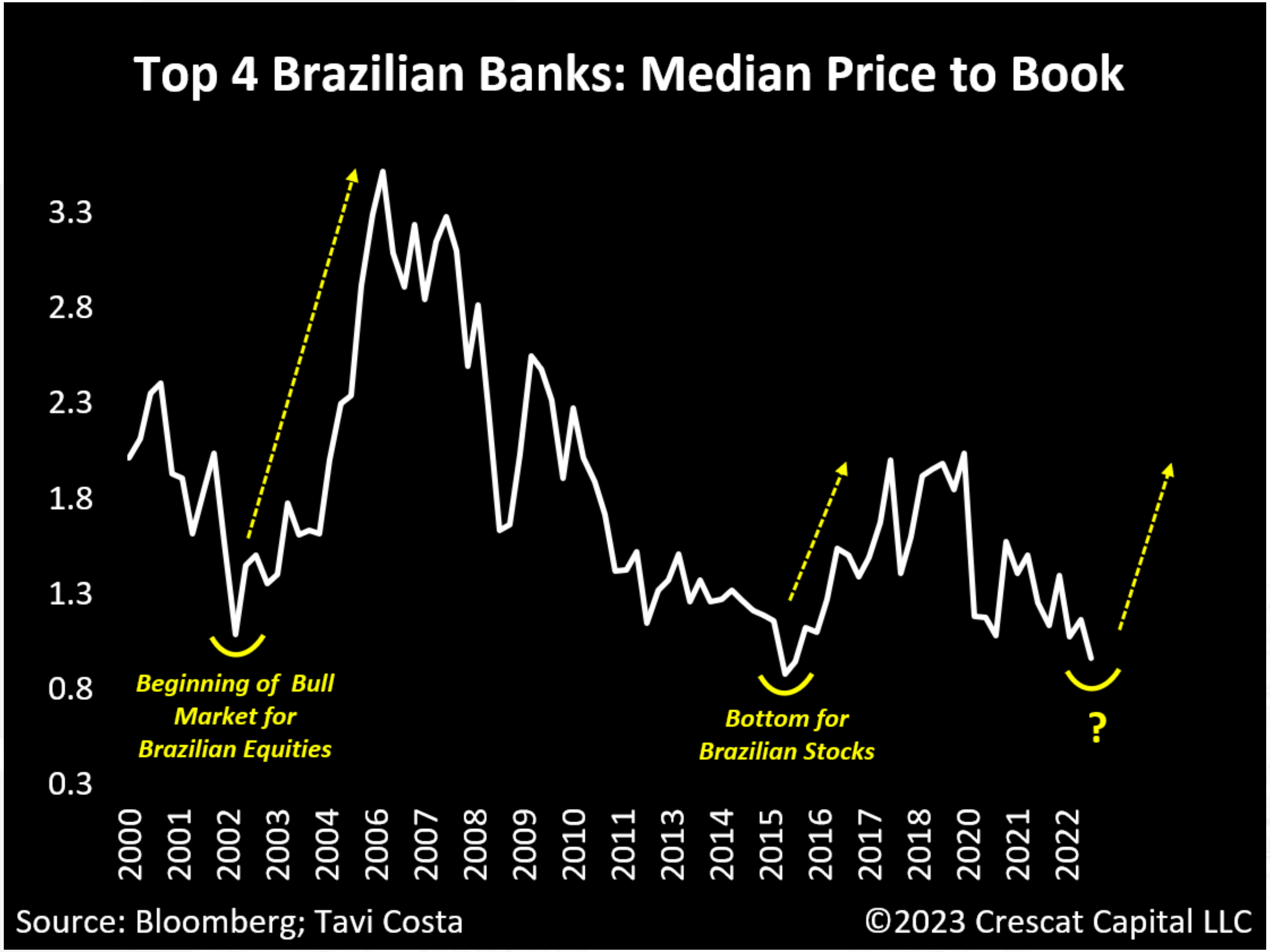
The last time we saw such undervalued prices was in the early 2000s, when Brazilian stocks entered a bull market.



Brazilian equities are also historically undervalued relative to US stocks.

Brazilian stocks significantly outperformed other emerging markets and developed economies despite a challenging year.

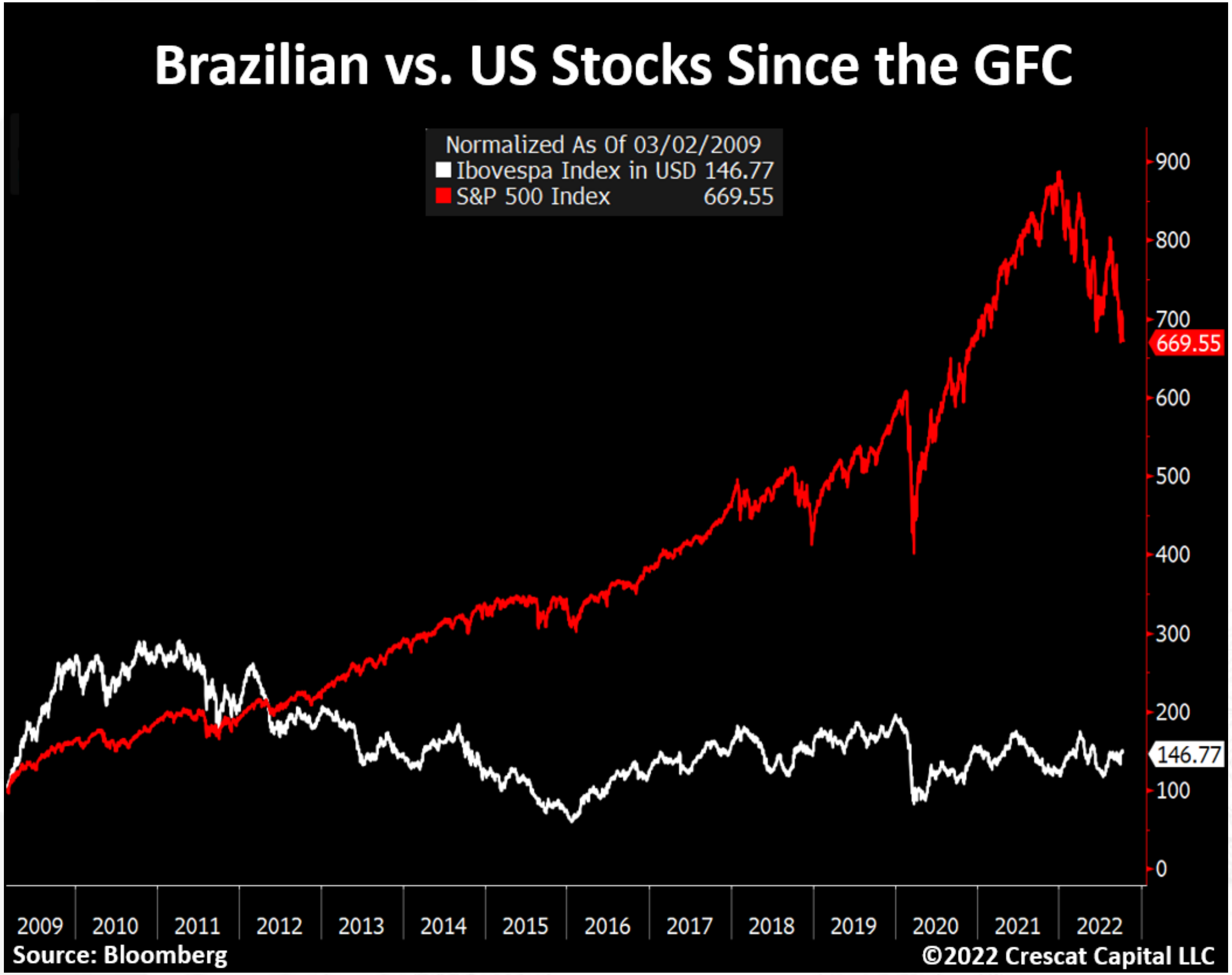
A geopolitically neutral net exporter of commodities with a historically undervalued equity market.



Brazilian banks are currently trading at one of lowest price-to-book levels in history.

Prior times when this industry was trading at such cheap multiples also marked great buying opportunities.

Brazilian equities are insanely cheap.
Here is one of the largest steel producers now on the brink of a major breakout.
The stock is currently trading at less than 4x earnings with a 24% FCF yield.
Not to mention, its dividend policy is at a 30% payout.



Note how Brazilian equities have massively underperformed US stocks since the Global Financial Crisis.

Note how Brazilian equities have massively underperformed US stocks since the Global Financial Crisis.

While we rather be long the Brazilian equities that offer even further asymmetry, the simplistic part of the thesis is to be buyers of natural resource-rich economies and sellers of net importers of commodities.

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