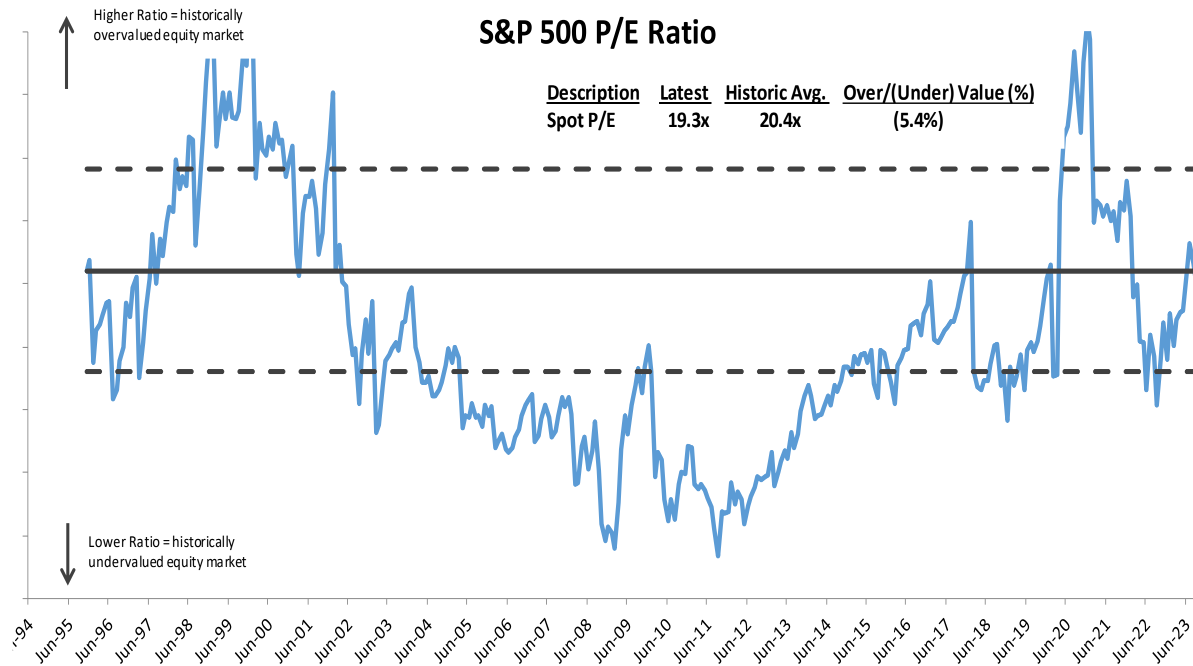
Market Report – Titan Investment Management LLC

November 6, 2023

Earnings:



Top level valuations indicate a market that is neither cheap or rich. The market is currently trading with a slight discount but remains well within the historical norm.

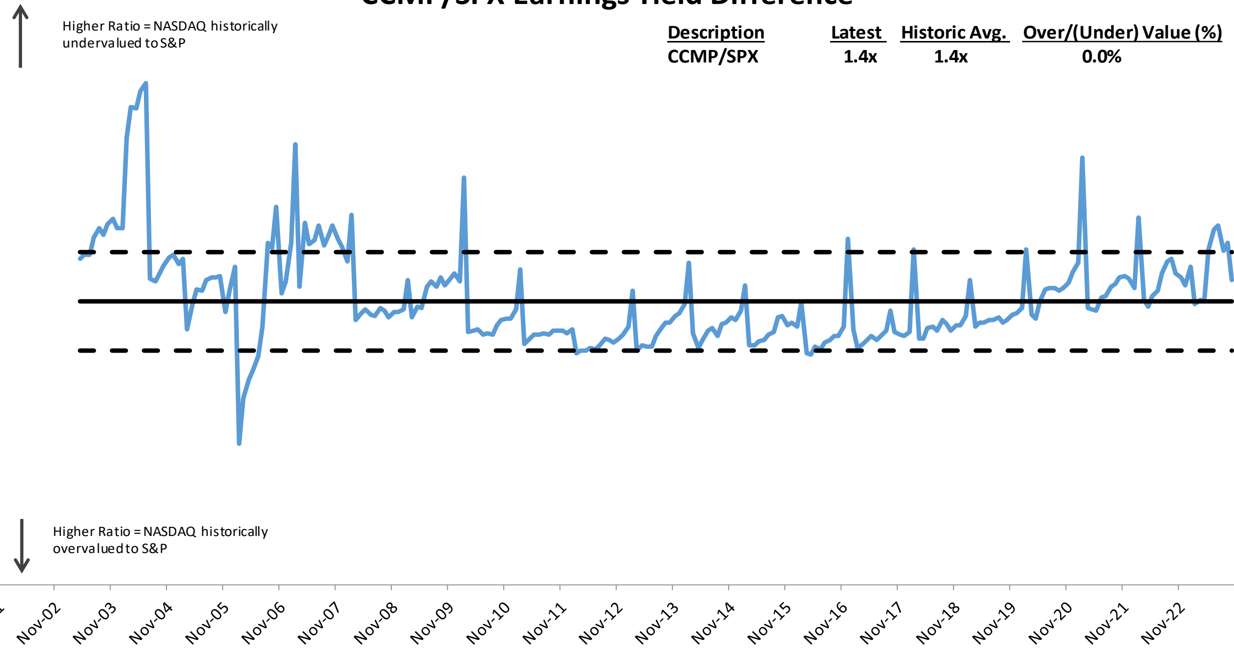
With Q3 earnings largely behind the results were largely positive. 92% of S&P 500 constituents have reported with 81% and 61% beating bottom- and top-line expectations. In addition, earnings grew by 4.1% YoY and in comparison, to an expectation of -0.3%.

This positive result was also holistic in nature. The bulk of economic sectors made up this percentage with the only laggards being Healthcare, Energy, and Materials. The latter two were simply weakness on the biggest needle mover for their respective industry – commodity prices.

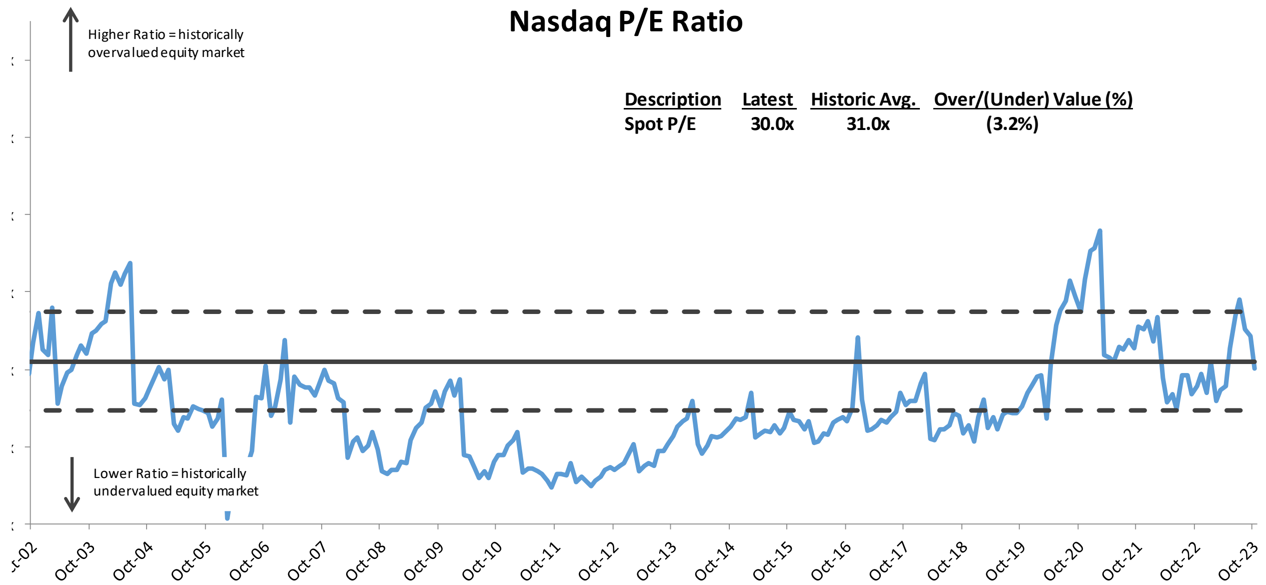
There is only really one data point that showed any signs of cracking and that was sales. More than half beat expectations, but this is below the historic average of 71% and was particularly the case in Energy, Materials, and Utilities. Fortunately, this concentrated weakness can be explained by the price of commodities and their dramatic decline compared to the previous 12 months. The sheer volatility of these industries is why Titan is and historically been underweight these sectors. No matter how effective an Oil & Gas or Utility management team may be, their destiny is defined by factors largely out of their control.

Valuations:

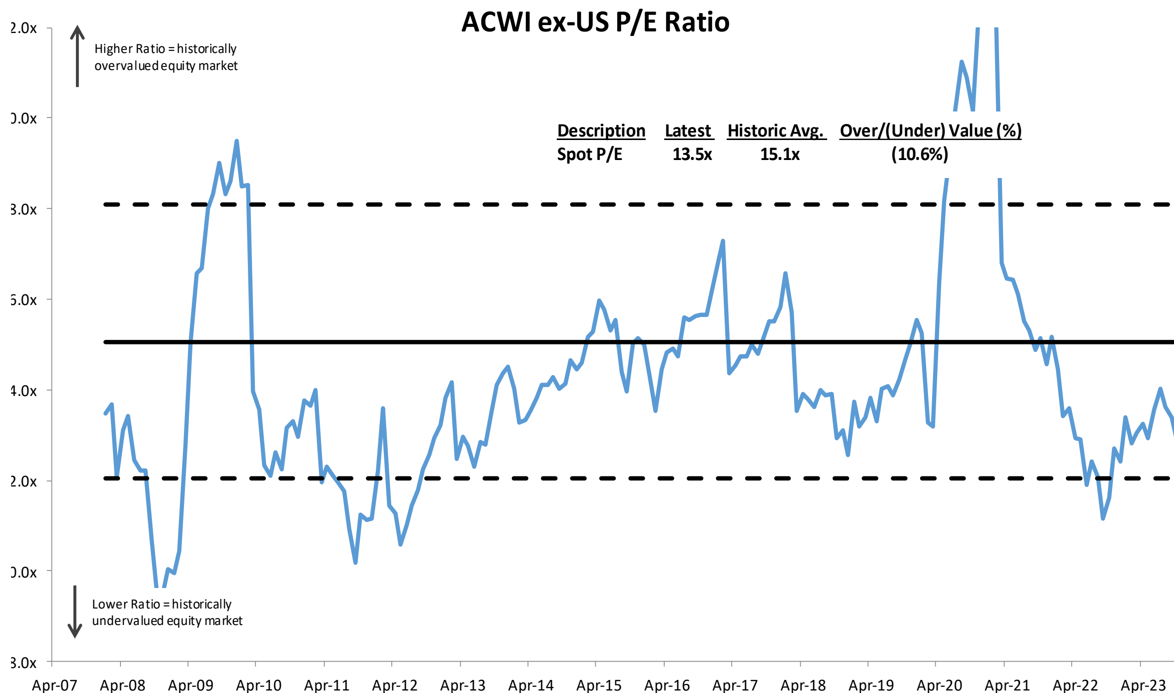
Given the neutral outlook from a top-level perspective, the following graphs seek to highlight any sort of discrepancies taking place below the surface.



Despite the strength in Technology (AI) YTD, the overall technology sector relative to the market remains within its historical norm.



An argument could be made that the rest of the world offers a larger discount compared to the S&P 500 (US). However, this discount is largely a function of the Chinese economy being in a sharp contraction.



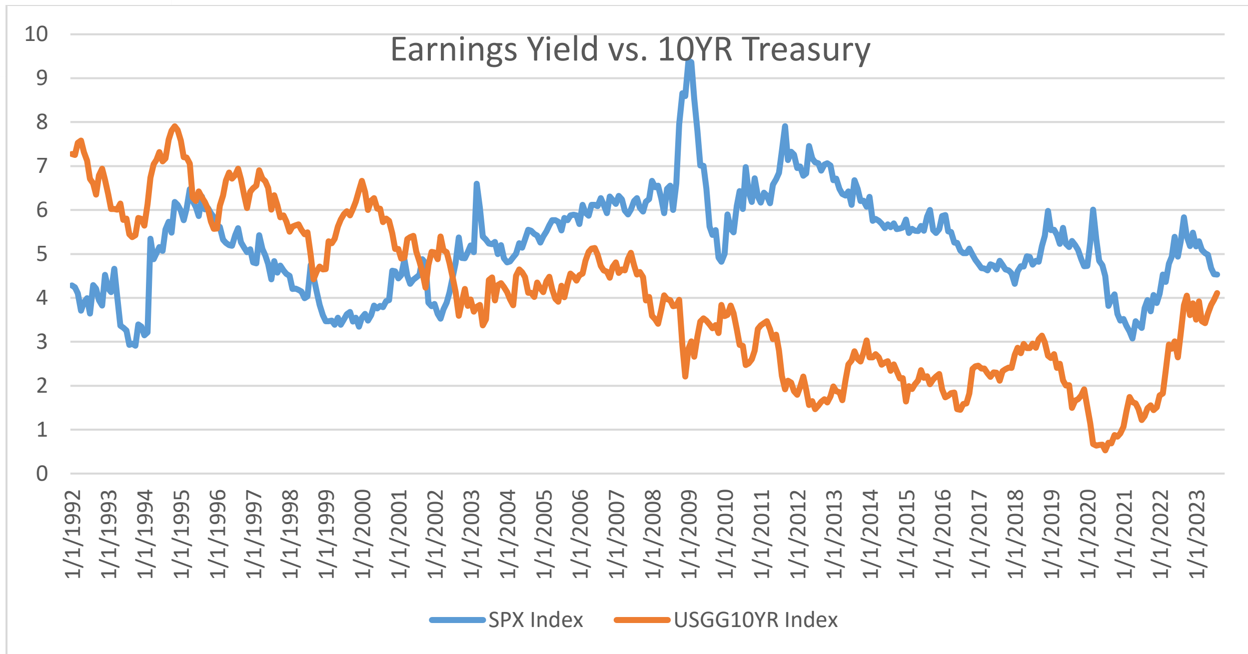
Given this discount is for taking on the risk of China, Titan does not envision general international stock markets to be cheap given China still exhibits the following:

1) Youth unemployment (16-24) is at an all-time high of 21.3%.
2) China's largest and stated owned property developers; China Evergrande and Country Garden have defaulted on billions with no end in sight.
    a. Real estate makes up over 20% of China's GDP.
3) Prices are declining (deflation), reducing profits, causing unemployment to rise, which results in less sales, more layoffs, into a downward spiral.
4) China's one-child policy of the past has created a demographic nightmare.
    a. Younger generations (<24 years of age) males outnumber females by at least 1.2 to 1.
    b. China's historic economic tailwind (cheap labor) is quickly becoming a thing of the past.

Thus, not only is China dealing with a 2008 like scenario in terms of real estate and debt, but their long-term economic characteristics have rotted their economic roots.

When comparing valuation metrics across equity markets, not one data point jumps out for better or worse. However, where things begin to show signs of opportunity is by comparing equity markets to bond markets.

The current difference between the earnings yield of the S&P 500 as well as the 10YR Treasury rate is the narrowest it has been in over 20 years. This is not to say sell all your stocks and buy bonds, but more importantly a new narrative of "it pays to be patient." Given no one area of the economy or country is at a material discount, Treasury Bills (daily liquidity) are currently paying 5.50%.

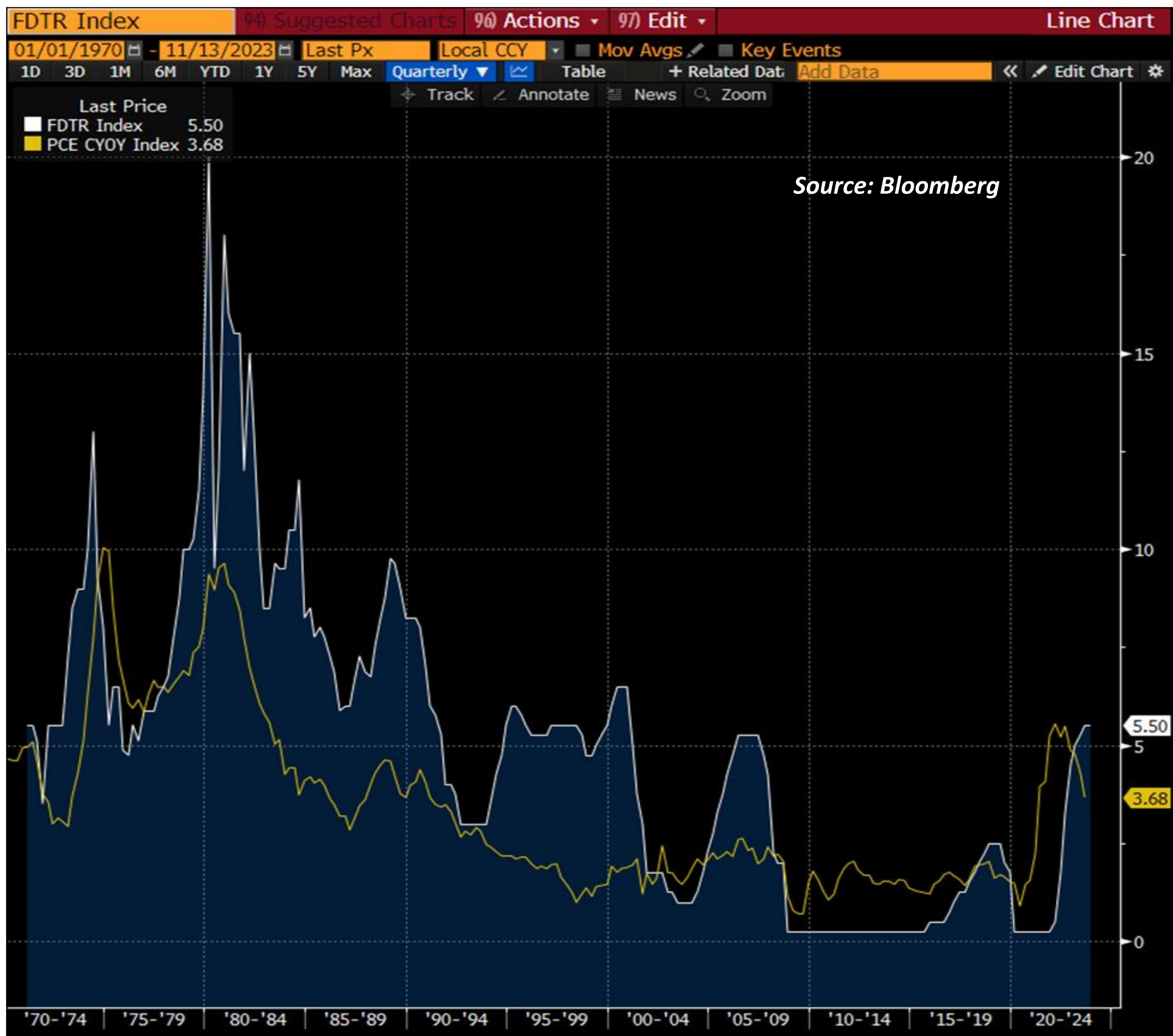


Conclusion:

Given the overall strength in earnings, Titan does not see any sort of economic calamity around the corner, especially in the US. At the same time, not one sector of the economy is massively over or under valued. From a top level this has set the following narrative for Titan and near term valuations.

1) **It Pays To Be Patient.** We are not in a rush to make a decision. This is especially the case given cash can earn 5.50% risk free.
2) **Avoid China, Stay Home.** The situation in China continues to deteriorate. Despite Chinese valuation metrics being depressed, they are depressed for meaningful reasons and cash is better spent on the Homefront (US).

Higher or Longer

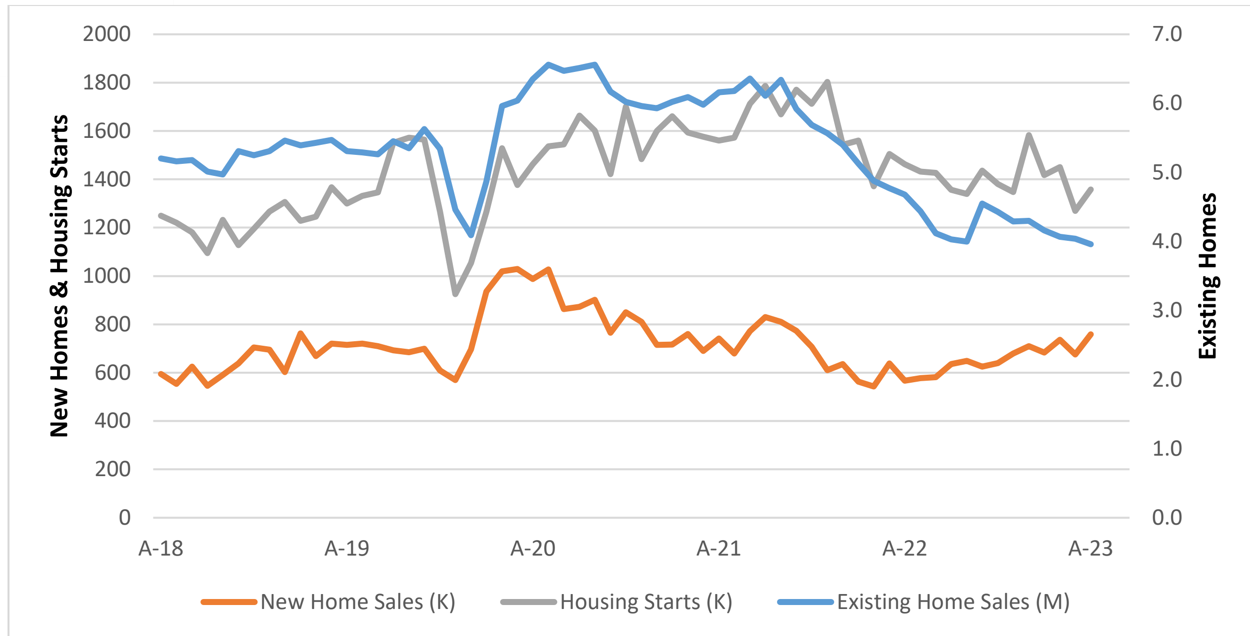


Going all the way back to the 1970s when Fed policy truly took form, the FOMC has rarely had to be so aggressive in raising overnight interest rates. While this has led to higher interest rates across the board for mortgages, cars, credit cards, and student loans, it also pulled inflation back down. This fight against inflation is far from over, but metrics are currently moving in the right direction.

Transient vs. Enduring

Towards the end of 2021, every economic policy maker was calling for transient inflation. As recent history has shown it was not transient and has resulted in Americans paying significantly more for gas and groceries, while taking on a higher interest rate for a mortgage.

At the end of the day food and gas are commodities dictated by supply and demand. The inflation of 2022 was largely an issue of supply being slow to comeback in a post COVID world. Fast forward to today and gas prices have come back down while grocery prices have stabilized. Thus, food and gas have proven to be transient factors in inflation. Housing on the other hand has had a very different outcome.



The 30YR mortgage has increased from under 3% to over 8% in the past 2 years. The average and rational consumer will be incredibly slow to sell their existing home (paying a 3% mortgage) to buy a new home (paying an 8% mortgage). This decision or lack thereof has removed 90% of the historic housing supply (that being existing homes). The only way this supply drop could be offset is with a near 10X increase in new home construction. This increase in production is an economic impossibility and has set the stage for supply to be meaningfully depressed compared to demand for the foreseeable future.

At the same time commercial real estate debt tends to be floating after a set period. Prior to 2022, the commercial real estate market had a massive tailwind of interest rates moving lower and lower. Thereby providing the ability for commercial real estate owners to refinance at the end of their fixed period into a lower rate. This trend is over, and these owners will now be paying a higher interest rate as the fixed period rolls off.

These new trends of no supply and higher financing costs will push the cost of rent and home ownership higher and higher. These price increases are going to prove to be enduring rather than transient. The only way this proves to not be enduring is if interest rates plummet. The only way interest rates will plummet is if there is an economic recession at which point the FOMC will be forced to cut.

Historic Periods of High Overnight Rates

Year	Change in Rates (bp)	Time at Peak (Months)	S&P 500 Return	S&P 500 Return Next 6 Months
1973	750bp	1	(7.42%)	(0.34%)
1978	1325bp	12	13.49%	(4.05%)
1988	300bp	3	8.83%	12.99%
1994	300bp	66	18.25%	(6.70%)
2004	425bp	12	20.57%	(1.29%)
2018	225bp	12	18.54%	(3.09%)
2023	525bp	2 & Counting	2.83%	N/A

The historic reference of how long overnight interest rates will stay elevated is incredibly volatile with a whopping dataset of 7 observations. However, using history as some form of benchmark plus the stickiness of housing and one could easily paint a scenario where interest rates remain elevated for at least a year. This projection has both good and bad news:

- Good News – Historically when the FOMC has capped out in terms of rate increases, the markets in general tend to be very robust in terms of performance.
- Bad News – More and more Americans are going to turn into renters rather than homeowners and set a poor economic outlook for future generation's net worth.

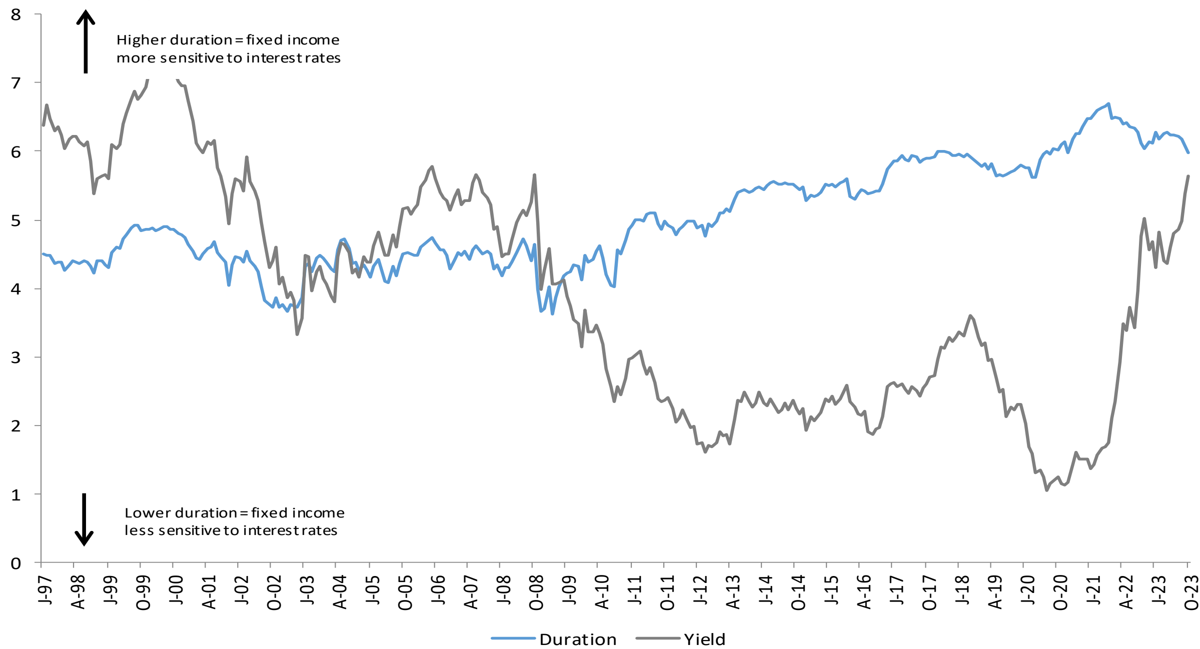
What will deserve more attention is when the FOMC is forced to reduce interest rates. Outside of 1994 (soft landing) all other periods were me with economic duress (COVID, Great Recession, S&L Crisis, and Oil Embargos). These periods have historically seen weakness from the overall market that Titan is going to be incredibly tactical about.

Conclusion

The FOMC has reduced inflation on the back of lower energy prices and stable grocery prices. However, inflation is going to prove to be more enduring on the back of housing. The FOMC cannot raise rates to combat housing inflation as it will only raise the price of a mortgage/commercial loan and thereby raise the price of a mortgage/rental payment. Expect overnight interest rates to remain elevated for a prolonged period of time that will benefit older generations (tend to have a lower debt balance), but significantly hinder young generations (tend to have a higher debt balance).

The incremental cash spent on a mortgage or rent will take away from discretionary purchases in retail, dining out, and travel. Titan will be avoiding these sectors of the economy at large as they tend to thrive under the scenario of a strengthening consumer. This is not to say the consumer is set to fail, but a reprioritization in spending is going to take place across America. This is especially the case for younger generations.

Bond Market



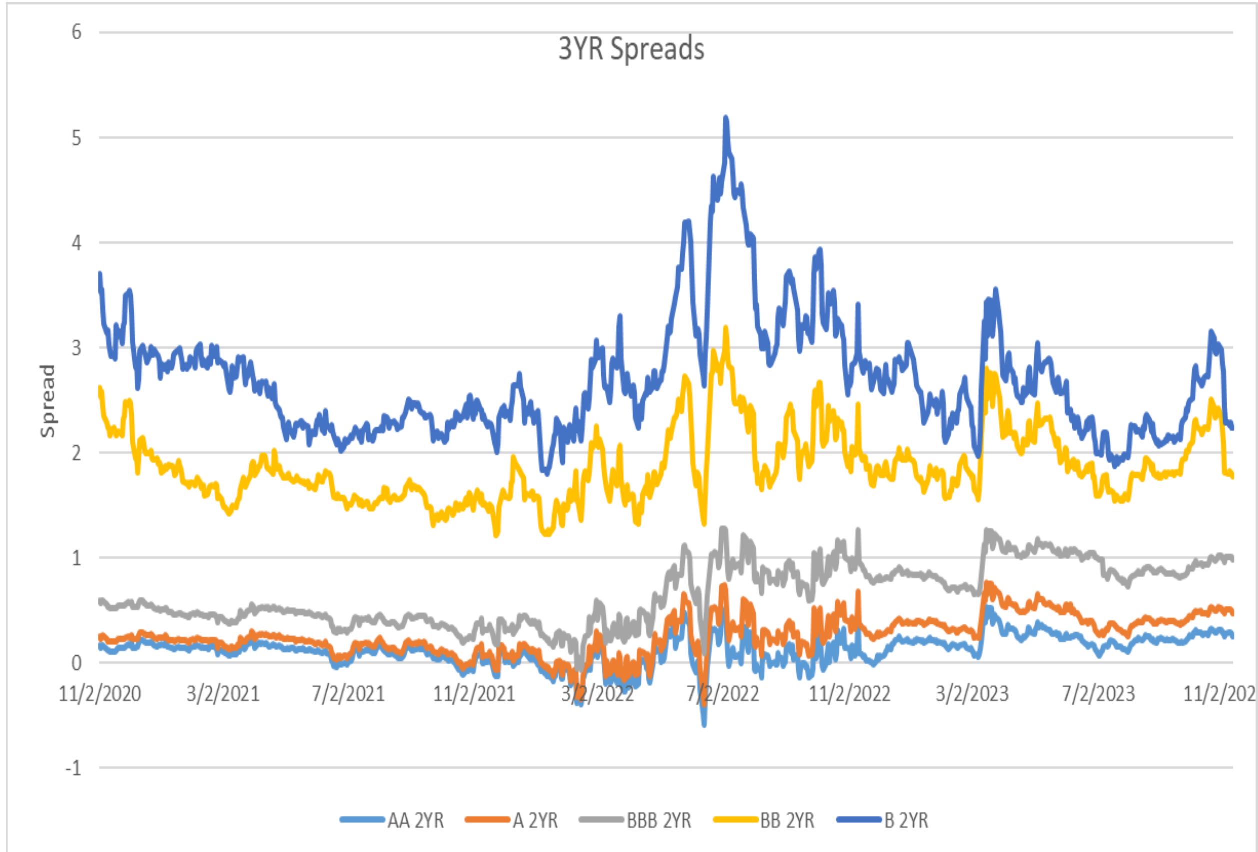
Given the actions of the FOMC in regard to inflation, it is no surprise interest rates have moved higher across the board. The interest rate afforded by the bond market is near a 20 year high but comes with a duration north of 6x.

Quick Reminder – Duration is the measure in the bond's price for a 100bp change in interest rates. Example, a duration of 6x will result in a bond appreciating/depreciating 6% if interest rates move lower/higher 100bp.

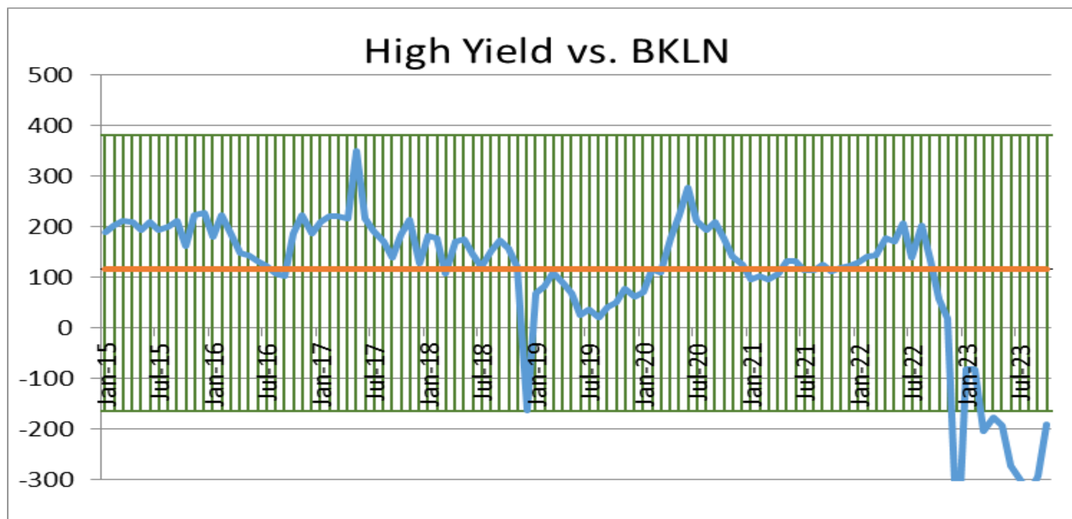
While a higher interest rate for the same amount of credit risk is appealing, this 5.65% yield comes with a duration north of 6x.

US Treasury Bills offer a ~5.50% yield with no duration risk. As a matter of fact this is one of the largest investments that make up the average US bank's money market and/or what they are buying with our checking/savings dollars. Titan sees little reason why it should take on significant duration risk for a minimal increase in yield.

At the same time credit spreads have not meaningfully moved wider to offer incremental yield for taking on the risk of a corporation going bankrupt.



One final area of focus is high yield and floating rate debt.



The surprising resilience of credit spreads has made high yield an overvalued asset class relative to floating rate peers who offer a similar credit profile.

Defaults remain near historic lows providing some rational why credit spreads remain historically stable. However, this lack of default and/or strength in credit quality leans into the narrative of floating rate debt. To put this in perspective consider the following characteristics of floating rate debt vs. high yield.

Name	High Yield (JNK)	Floating Rate (BKLN)
Duration	3.53x	0.00x
Yield	6.75%	8.71%
COVID Panic Return	(22.0%)	(23.9%)
2022 High Interest Rate Return	(12.20%)	(2.51%)

To sum up this graph, floating rate debt provides a higher yield, for less interest rate risk, and similar drawdown risk in the event of economic duress.

Conclusion

Considering the inverted yield curve, credit spreads, defaults, and duration, Titan believes a barbell approach in terms of short duration, but credit risk is ideal. This approach will entail liquidating all high yield debt and investing the proceeds into floating rate notes.

This barbell approach that is equally weighted in terms of duration, but opposite in terms of credit risk will serve to be more and more appealing with the FOMC keeping interest rates elevated for the foreseeable future.

As always if you have any questions, do not hesitate to reach out.

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