

## Mid-Late cycle Transition, Recessionary Bear Market or Bursting of a Super bubble?

We humans are very poorly wired for investing. Investors feel happier when stocks become expensive and feel miserable when they get cheap. The current episode of a 10-15% correction in stock markets within three weeks is another demonstration of how emotionally charged/scared investors can get. Consider this: S&P 500 was at 4300 on June 30 2021 and had made a 15% return - one of the record half-year outcomes. Everything on the tv networks at that time was about how good everything, from the economy to earnings was faring. Now, we are at 4300 again, earnings have grown 10% - making stocks cheaper - but all we hear is the doom and gloom about how bad the stock market is. Charlie Munger once said, we humans are great at rationalizing but are very irrational beings.

FHPF also has “suffered” a similar decline as the broader markets month to date. In June 2021 we were 80% invested, citing expensive valuations. And we (until) yesterday were still at exact 80% allocation level. **We believe the investing game is primarily won by NOT doing two things: “You do not buy when companies, even good ones, are expensive and do not sell when even bad ones are cheap.”** We have looked at each one of the 39 companies in the portfolio and asked ourselves: will they grow earnings and cash flows, ideally both, by a minimum of 10%? The answer was yes and in most cases an emphatic yes, since we are expecting 17% EPS and FCF growth in our portfolio companies on average. We have not sold a single stock in the portfolio. Owning real, high-quality businesses makes this easier to do.

Are we buying? The most pertinent question from our investors. The answer is Yes and the details are included later in this note.

Equity markets are generally a very good forecaster of the 12 to 18 months’ economic outlook. We believe the current correction is trying to discount one of three possible scenarios.

### Mid Cycle/Late Cycle Transitioning Spasm: A 10-20% correction (66% probability)

The current sell-off started when the US Fed meeting minutes were released on Jan 5<sup>th</sup>, of a meeting that took place on Dec 15<sup>th</sup>. Market response to that meeting and the subsequent press conference on that day was a move 1.5-2.5% higher, depending on whether you choose S&P or Nasdaq! In the Fed minutes, what has seemingly spooked investors is the hint of Quantitative Tightening (QT) starting as early as middle of this year; a faster liquidity withdrawal than most investors were expecting. The biggest fear amongst investors is that the Fed is behind the curve against inflation, the economy is very overheated, hence the Fed would need to be doing all kinds of tightening very, very fast. We believe these fears are way over hyped. In our opinion, US and global economies are ok but not as hot as some of the central banks would like to project. In our view, ***the current correction is primarily about the typical transition of the economic cycle towards mid to late stage, where economy slows and correction takes place when the baton usually changes hands from the beneficiaries of early recovery / fad stocks to more stable growth companies.***

### A Recessionary Bear Market: A 20-30% market decline (20% probability)

Our (contrarian) opinion is that the policy mistake by central banks would not be lagging behind the curve (too late for that) but would be now over tightening in an over indebted-slowng economy. Central banks in the last six months have found it very difficult to stick to an economic view. Only in August 2021, the Federal reserve led by Chairman Powel who lectured about the permanent forces of deflation (a view which frankly we still agree with) seems to have transcended to a very hawkish stance now. Only one anecdote: never in history, ever, has an economic cycle in the US ended with the labor market smaller than it was at the peak of the last cycle. Currently, the labor market employs 6 million or 3% fewer people than last cycle. However, the probability of a recessionary bear

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market largely depends on how hawkish and panicky the central banks become in their policy making. We still think that sanity should prevail and we would not be going into a recessionary bear market.

### Bursting a Super Bubble: A 30-60% market drop (A 10% probability)

Well known investor Jeremy Grantham, for whom we have a lot of respect, has doubled down this weekend on his call on the US market as the 4th Super bubble of the last 100 years. To some extent we agree with him on the level of excesses and over valuations including some part of the equity market, global housing market for sure and the half bubble in commodities. However, we do believe that this time is different (!) **The US equity markets are not thriving and beating the global equity markets for last 10 years because of the speculative growth names that did not exist before pandemic, but due to the US' entrepreneurial excellence that created the four most amazing companies of history: Apple, Amazon, Google and Microsoft.** If we are wrong and equities are heading into a bubble bursting phase at the index level then these four companies' earning moats must have been jeopardized and we will see earnings declines in the very near future. If we don't, we think we are not yet close to an overall equity bubble bursting phase.

### Positioning / Hedging

We mentioned to you in our year end that we will be increasing our equity exposure in 2022 from 80% to 90%. We are taking advantage of this correction by adding to our quality names at discounted prices – the pull back has been somewhat timely for us. In the last two equity sessions we have put cash to work. We started buying the large cap stocks and companies where we see the most growth this year, not necessarily the ones that have beaten down the most in our portfolio. Although we assign the 2/3<sup>rd</sup> probability to current correction as the mid-life crisis in markets, we are also prepared with our options hedging book to face a recessionary bear market or a bursting bubble. Some of you might be wondering why our (preliminary month-to-date) result is same as the broader equity market and were we hedged before or during the sell off? We were hedged 18% with SPY options on Jan-1 which we increased to 45% by Jan-18<sup>th</sup>. However, it was not sufficient to control the beta of our companies. The median stock in our portfolio was down 15% (less than Microsoft and Google). If we had not hedged, we would have been down much more.

We have also suffered from basis risk as our strategy has been to use the cheaper S&P500 options which due to cross industry rotation (into energy/banks) held up significantly compared to the more growth focused Nasdaq. We contend over time when markets dislocate correlations move to one – we just have to take this one on the chin. Higher options volatility also increases our ability to generate liquidity for the portfolio around our preferred names. As a reminder, 40% of our returns from last year were generated from hedges/trades in an overpriced market. We would like to think we can emulate this in a bear market.

We are very encouraged some of our investors have already increased their investments with us in January.

We started to write this note this morning while markets were continuing to melt, and perhaps had reached to the near-term capitulation by the time we finished. That said, we don't think we have so much foresight into the near term. ***We continue to focus on the macro situation and more importantly the bottom-up earnings profile of our highly profitable portfolio companies and make investment decisions accordingly.***

We end with one of the nicest quotes we read this morning:

*"If the path be beautiful, let us not ask where it leads." Anatole France*