2nd Quarter 2022

CAZ Investments
Quarterly Letter

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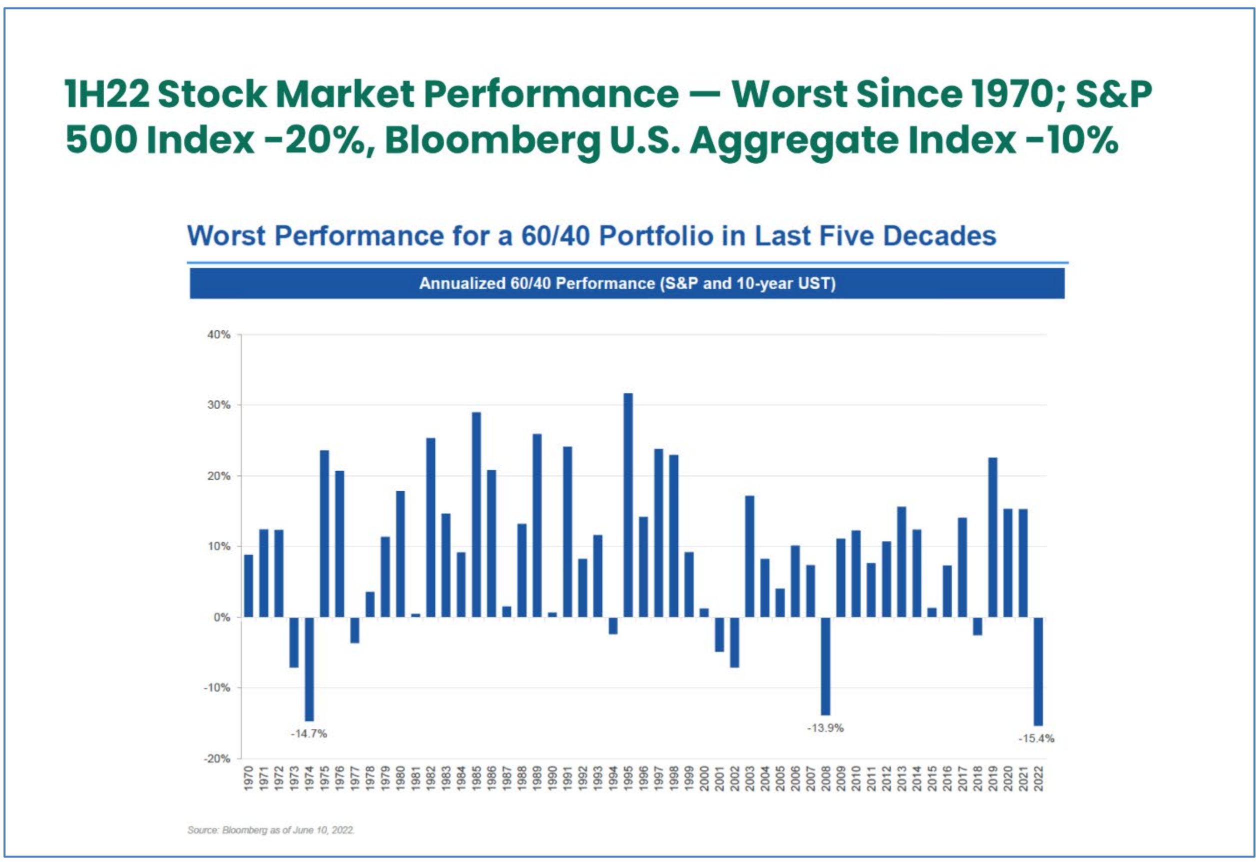
2Q 2022 – The Bear Market is Confirmed… and the Paradox of the Summer Rally

That is a longer title than usual, but these are unusual times….in so many ways! The bear market of 2022 was confirmed in June when the S&P 500 reached a decline of more than 20% from its highs, with many other indices suffering declines of more than 30%.

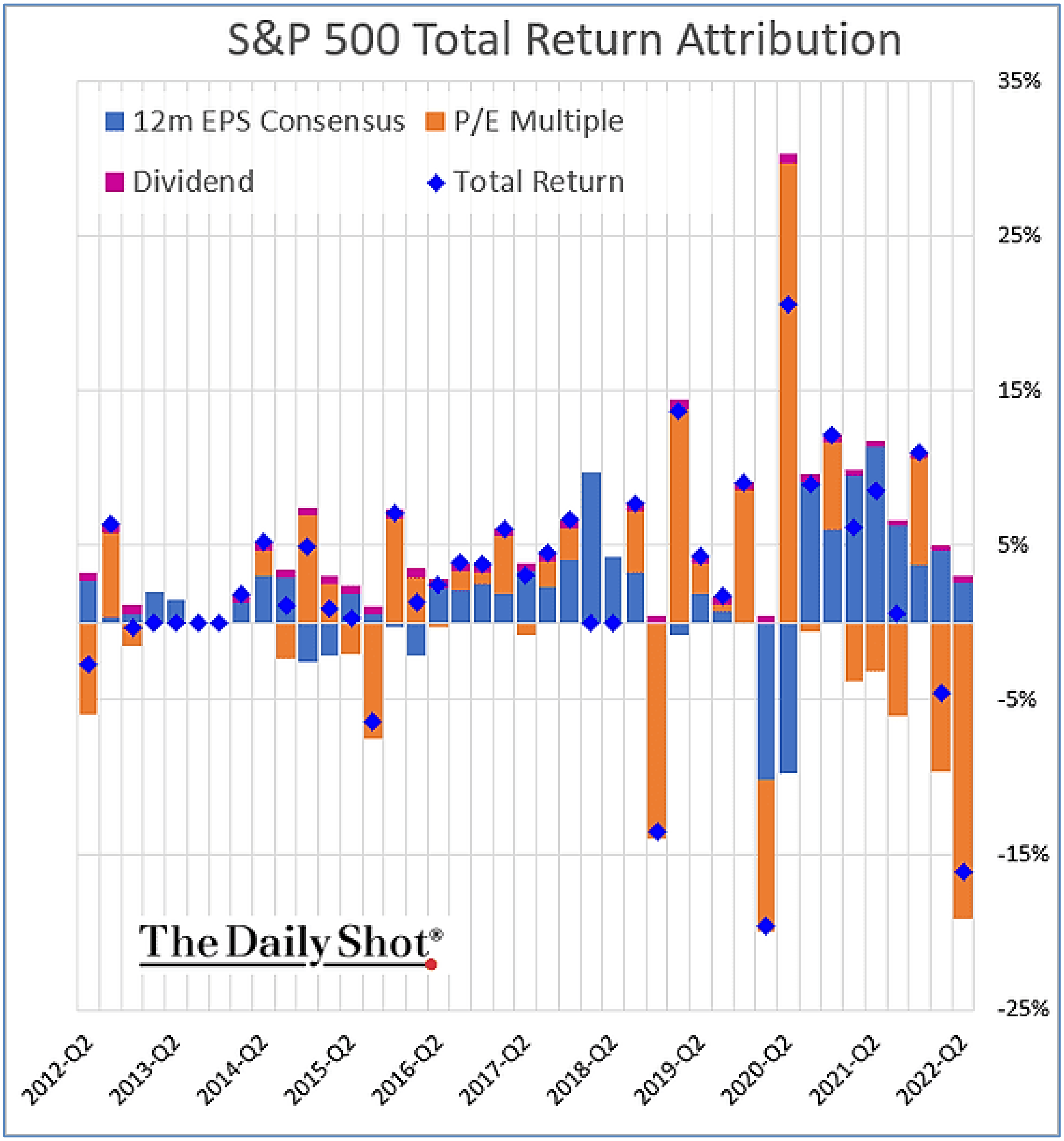
As we evaluate what investors should do from this point, we need to start with a recap of the 2nd quarter. Simply stated, it was lousy for any investor in virtually any liquid asset class. Whether someone owned stocks or bonds, they got hammered. If they happened to be in the speculative corners of the market, like meme stocks or cryptocurrencies, they were mostly obliterated. There were countless stories of investors losing 20-50% of their money in just the month of June, as the bear market accelerated. To illustrate just how bad it has been for traditional investors, here is a chart that shows the performance of the "standard" 60% stock / 40% bond portfolio for the first half of the year:



Source: FactSet

Yes, it was the worst first half of the year for a 60/40 investor in 52 years! We reiterated last fall and at our Themes event in January that investors who were sticking with plain vanilla investments were taking vastly more risk than they likely realized. Those fears have now come true and yet, in shocking fashion, both the stock market and bond market rallied in July and August… more to come on that subject in the next few paragraphs.

It has been a persistent refrain from us that valuations were our primary concern, not earnings growth, as we felt that valuations were simply pricing in perfection. What the chart below shows is that earnings (12m EPS Consensus) have continued to grow, but valuations suffered a major correction.



As the reader can see, earnings growth was positive, and there was a reasonable dividend yield, but valuations dropped by nearly 20% in the 2nd quarter alone and this caused stocks to drop sharply. This is going to happen a few times this letter, because the words need to be repeated, but here is what we said in our first quarter letter on the same valuation subject:

> *That is what investors experienced, and it is not fun, but it is a lot better than the "double punch to the gut" that we have been concerned about for the last few quarters. That is where earnings DROP and valuations DROP, at the same time… That is what creates bear markets like we all experienced in 2008.*

That means now it is time to talk about expectations for earnings. The picture is not pretty and the "second punch" is likely just around the corner. The reports from companies in the 2nd quarter were not horrible, but their guidance was disconcerting, and analysts have begun to get more realistic about their expectations for the 3rd quarter:

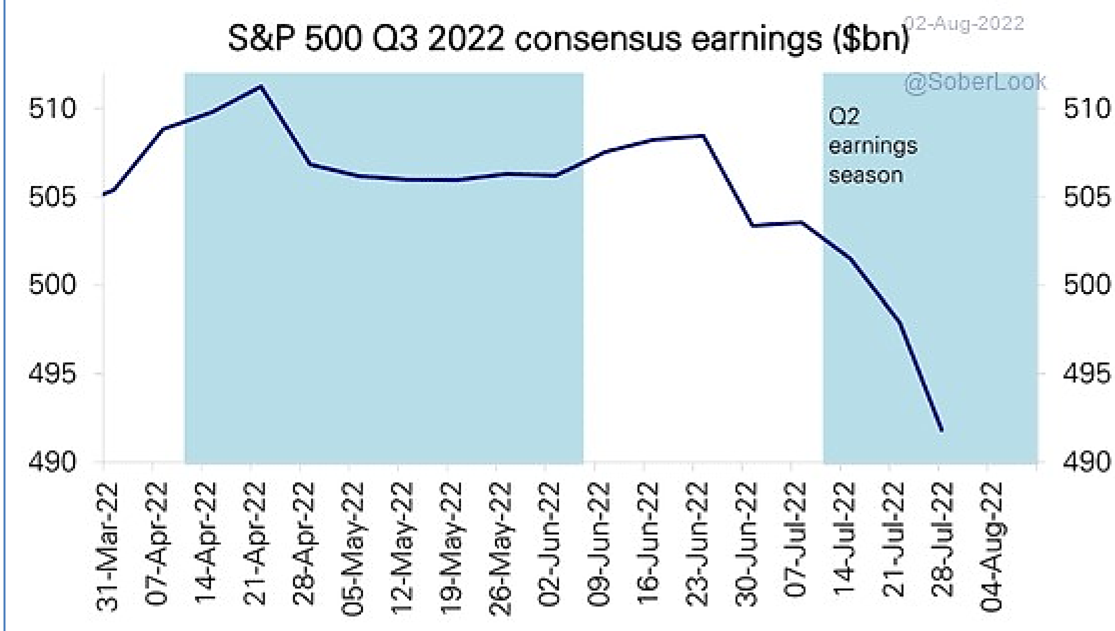


Figure 36: Q3 2022 earnings estimates have been cut sharply since the start of the earnings season

Source : Bloomberg Finance LP, Deutsche Bank Asset Allocation

When the reader sees the compression of valuations and the growing expectations that earnings will be more challenged, they would not be blamed if they expected to see a sharp stock market decline in July and August. But they would likely be quite surprised to learn that stocks actually rallied dramatically. As a matter of fact, the rally in the S&P 500 was nearly 19% from the June lows to the time of this letter on August 15th. How can that be? Quite simple, and textbook when one studies history. Obviously, anything can and sometimes does happen, but this feels like nearly every other "bear market rally" that has been seen over the last 120 years. Most people do not realize it but some of the most extreme rallies in stock prices have occurred in the midst of a bear market.

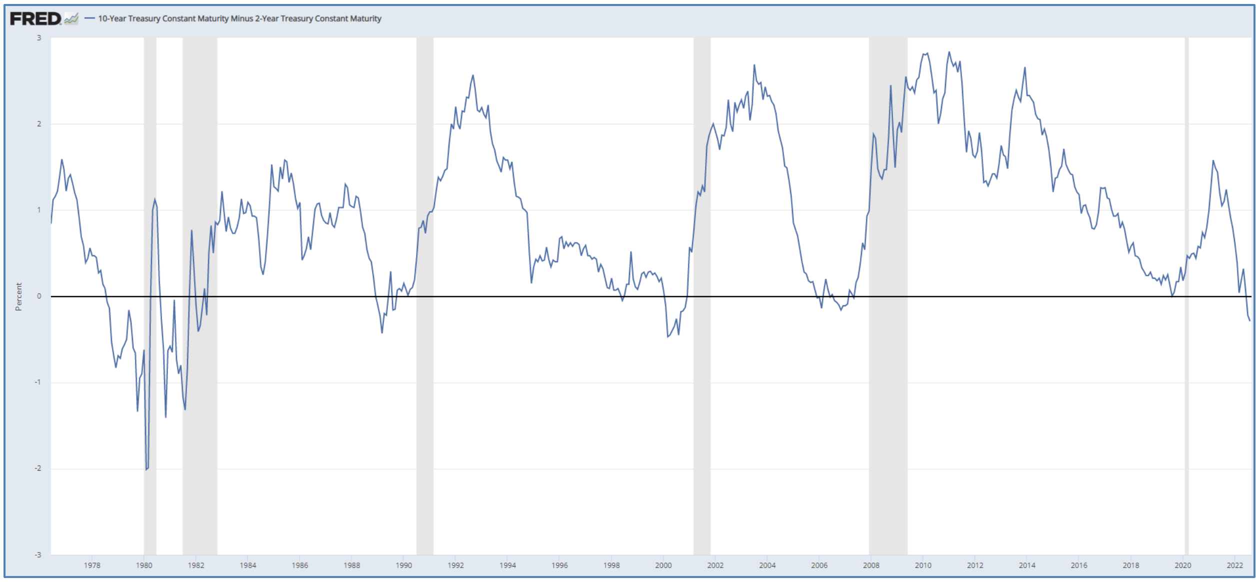
With that said, it is important to note that every bear market will end, and stocks will usually rally long before the actual trough in earnings and the economy. Yes, that could theoretically be happening here as the market is definitely a "forward looking animal." That just does not feel like what is happening today, as this feels a lot more like "hope" than a forecast of the cycle turning. (And as we have stated many times over the years, "hope is not a good investment strategy…") The Federal Reserve has no choice but to continue to tighten monetary policy, both by raising interest rates and with quantitative tightening, in order to combat the worst inflation we have seen in nearly 50 years. Everyone should expect them to talk about "soft landings" and a "manageable slowdown," but the result is the same and that is a recession. Yes, we are technically in a recession, regardless of what anyone may say, as the definition has always been two quarters of negative Gross Domestic Product ("GDP") growth. Debates rage as to whether or not that definition should still hold today but, regardless of what one chooses to call it, the economy is slowing rapidly, and consumers are feeling the significant pain from inflation in just about everything that matters to them, such as food, housing, energy, services, transportation etc. Therefore, the picture of earnings is going to continue to get worse as consumer demand slows and profit margins shrink. It is impossible to know if we will actually see a decline in earnings rather than just less growth, but either result is expected to be bad for stocks until they get much, much less expensive.

As a side note, there were some that argued that stocks became at least fairly valued at the depths of the June lows, and we actually agreed with them in some sectors. That sharp decline in valuations caused us to adjust the CAZ Scale to a 2, and to put a fair amount of capital to work, but then the blistering rally of July and August caused us to go right back to **a "1" on the CAZ Scale and we strongly believe that the risk/reward from these levels is not favorable.** For total clarity, we do not typically adjust the scale very often, but the volatility in valuations this year has not been typical… So that no one can misunderstand how we feel, we are of the opinion that we have been in the midst of one of the biggest "sucker rallies" in history. We saw it multiple times in 2008, 2002 and 2000 and they tend to feel the same, with a combination of short covering and "don't miss out" buyers. Obviously, this time can be different but with the Fed tightening, no fiscal stimulus on the horizon, a hostile and rapidly deflating China, continuation of the war in Ukraine and a massive energy crisis in Europe, etc., it is really hard to paint a bullish picture.

Before we talk about what we believe investors should do we need to at least update everyone on the shape of the yield curve. The best way to set the stage for that discussion is to remind everyone what we said last quarter:

> *The Yield Curve is Predictive – The shape of the yield curve is one of the most accurate predictors of the future that exists in all of investing. If there is one economics concept that investors should understand, this is it… The yield curve is the difference between short-term interest rates and long-term interest rates, and it is a reflection of the collective market view as to the economic growth that is expected. Normally the yield curve is "steep", meaning that bonds that have a short time to maturity will trade at a lower yield than the bonds that have a long time to maturity. Why is this? It is because investors usually want to receive more yield if they are going to tie up their money for a long time. The yield curve is "flat" if short-term and long-term rates are basically the same. An "inverted" yield curve is where short-term rates are actually HIGHER than long-term rates. Investors are willing to accept a lower yield on longer dated bonds, because they expect yields to drop significantly from a slowdown in the economy. You may ask, how accurate is the yield curve as a predictor? Quite simple, it has been 100% accurate since World War II. Every time the 3-month U.S. Treasury yield has been higher than the 10-year yield, we have experienced a recession in the following 6 – 18 months.*

To provide a graphic illustration, see the chart below that illustrates the 2-year spread vs. the 10-year. The chart goes back to the early 1970's and the time periods shown in gray are the recessions. See how the curve inverts (the spread goes below the zero line) and then not very long thereafter the recession occurs.



Source: The Federal Reserve Bank of St. Louis

Well, as the chart clearly shows, the yield curve continues to forecast a slowing economy, with the 2-year trading at more than 48 basis points above the 10-year on August 9th. Further, if the Federal Reserve does what they have said they will do, which is to raise the Fed Funds rate by at least another 50 basis points in September, it will be virtually impossible for the 3-month yield to not be higher than the 10-year yield.

All of this points to a slowing economy, but will inflation likely disappear when the recession deepens? It is hard to say, but most likely not, as some of the factors driving inflation are not purely demand driven. Therefore, stagflation is our most likely outcome, which we have shown multiple times in these letters as being a really bad environment for both stocks and bonds. What has become quite a revelation to people in the last few months is how few investors have actually managed money in a stagflation environment. Think about it, we last had real stagflation in the 1970's and early 1980's. That means someone would have to be at least 62 to have even been in the investment business, and likely be in their mid-70's to have had material responsibility for portfolio management the last time we had the economic environment we are now facing. That means that very few investors even know what playbook to use, much less have run the plays personally! The result of this phenomena is that we can probably expect a lot of head fakes and false starts on the way to a true bear market bottom. Expect choppy markets and volatility as we work through the education of this generation of investors…

What Should Investors Do?

As mentioned earlier, sometimes the only thing that we can do is repeat what we said last quarter, as it summarized the views we still hold today. Here is what we said last quarter:

> *This is where we may start to sound a bit like a broken record, but a correction does not usually dramatically alter our world view. We believe that investors should remain uncorrelated to the public markets and absolutely be more focused on protecting capital, than trying to stretch for returns. There are many very interesting opportunities for investment today, but the majority of them simply are not in the public markets. That time will come, usually after a much more significant drawdown in stock prices. We will tell you when we believe that opportunity is there, just like we did in March 2020 and March*

> *2009. When the "scale" becomes a 3, 4 or 5, we will provide differentiated ways for investors to take advantage of the opportunity. Until that happens, we remain focused on preserving capital in the public markets and maximizing our returns via the private markets, where we believe we can best profit from the major themes we have confidence in.*

We continue to believe that the Growth of Private Assets and the Change in Consumer Behavior, specifically cord-cutting, are irrefutable themes that every investor should have exposure to, and we feel like we secured the very best access an investor can have. Please talk to us about these themes if you are not already fully invested with us in both. Outside of those areas, we are beginning in to see some glimmers of opportunity from the disruption in the economy, but we are being very patient. We will let you know when we allocate our personal capital to something new. In the meantime, stay focused on preservation of capital and allow us to share with you the details about where we are parking our personal cash and earning solid returns with very little risk, and weekly liquidity.

Our investor portal is at the finish line, and we will be rolling it out to you via separate correspondence in the next few weeks. The Team has put in an unbelievable amount of time, and we are confident that you will receive tremendous value from their efforts. Stay tuned for the specifics!

Another repeat from last quarter is that we need your help. We are growing very quickly and need to find high quality people to join our Team. Every area of the organization is hiring, including research, operations, trading, and investor relations. Please send us every elite performer you know that has at least a few years of business experience. If they are talented, we will find a seat on the bus for them. Most of the roles are based in Houston, but some of the investor relations positions can be located in other geographies. Please have all potential candidates email us via jobs@cazinvestments.com.

We hope everyone has a great finish to their summer and an outstanding fall. Please be on the lookout for fun gatherings we have planned in several different cities over the next few months and **save the date for our Themes for 2023 event, which will be held live in Houston on January 19th**. We are grateful for your partnership. All our very best to you and your family!