



## Holland Macro Views: (Credit Crunch – Series 2!)

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# Sea change, swimming naked & time bombs

Recent weeks have brought ever more economic/interest rate news and the roll-on of the banking crisis in the form of First Republic finally collapsing into JPM's arms. We make a few new reflections:

We have for some years agreed with David Einhorn's Jelly Donut view of monetary policy. This being that whilst a few interest rate cuts help economic activity (i.e. one donut tastes good) a too low level of interest rates is akin to too many donuts, making you (and the economy) feel sick. We have long held the view that super-low rates only helped those with top notch credit. i.e., Exor, Brookfield and Berkshire could borrow at 1%, but ordinary people still paid 15-20% on credit card bills. The result of having this starting view is that today we find ourselves with a number of knock-on non-consensus conclusions.

### [Swimming naked](#)

The section below is extracted from a piece we wrote last Autumn *Holland Views: Rejoicing as law and order is restored*. It can be found [here](#). We hope it serves as useful warm up for our new views that follow:

#### **Dodge City**

*Imagine yourself watching an old western movie. Dodge City has been an unruly place for years ruled by gangsters, thieves and speculators. The saloon does a brisk trade as does the house of the rising sun. The church is boarded up and the local sheriff is in the pocket of the thieves. When a new sheriff rolls into town cleaning it up you, the audience, cheer as he restores law and order. But what did the town's population think? It may depend on who you ask.*

*The old farmers and church goers of course welcomed the restoration of old values. But much of the town by then was made up of ne'er-do-wells. They liked drinking, gambling and other night-time activities. More than a few farmers' sons' heads had been turned away from ploughing and harvesting towards speculation and the easy life. Before we leave this story let's assume that pre-law and order being restored Dodge City was 80% speculators and 20% old timers. The speculators had grown rich for years. The old timers by contrast had been side-lined, bullied and ignored. Which are you? Bear in mind only 1 in 5 readers can be traditionalists.*

### **The consequence of the 2008 crisis**

Investing markets post-2008 (or maybe before) could be seen through this Dodge City lens. Many investors (speculators) wanted the easy life. Lots of growth and nice low interest rates to enable cheap leverage.

The bailout of the financial system in 2008 had a number of consequences:

- The most obvious was lasting low interest rates
- Less obvious was the bail-out backstop. Central banks would be perceived to again bail out businesses or markets in trouble. This ‘Fed Put’ as it is known presumed central banks were too fearful of the consequences to do otherwise.
- Some weak companies survived that should otherwise have failed due to super low interest rates. Additionally, markets awash with capital funded projects that otherwise they would have not at interest rates that supported those that love leverage.
- Another consequence was the changing behaviour of many who relied on, or interacted with markets. This included company managers, CIOs and politicians.
  - The latter group, politicians, found that with borrowing costs so cheap they could spend like never before, with seemingly no ill consequences.
  - As a result, bailouts and generosity became popular policy when once it was frugality and sound finance

Today things have changed... As Dorothy once said: “*We are not in Kansas anymore.*”

Source: Holland Views: Rejoicing as law and order is restored

## **The Whirlpool**

We remain relived and pleased to see interest rates normalise vs history. We expressed this view in the above piece and saw such a normalisation as unequivocally good news – long term.

Our view is that rates being cut from 3% to 0% had less a positive effect on Main Street than central bankers might have realised from their ivory towers. The 2022/23 reversal in interest rates have had the mirror effect, i.e. less of a dampening impact than expected also.

- This realisation we suspect is just sinking in at central banks. We think it has some important longer-term consequences.
- Until only very recently central banks thought super-low interest rates were a requirement for ongoing normal economic activity. They are now seeing that this belief was false.
- Today all the focus is on short term interest rate decisions and on where/when interest rates will peak. The debate on likely longer-term rates we think is much more important.
- **The long-term implications from central bankers’ realisation that super-low interest rates are not needed for normal economic activity we think is crucial.** The result is that a future world of 3-5% interest rates just became much more likely than one with 0-2% rates.

Much of what we saw during the period of super low rates we think was speculative and consistent with a booming end of market cycle. When considering the outlook for a likely very different future period we need to reflect on this past cycle that is finishing. We conclude; **it was long, extreme in nature, and sucked in a great many participants.** Our funds’ 2023 year-end letter spoke to this point:

*Such periods are often described as “bubbles”. Having now lived through a few, I don’t think this fully explains the psychological struggle investors experience trying to invest during these times. “Whirlpool” might be better image. Imagine you are in a large lake and a powerful whirlpool emerges in the centre. More and more people are being sucked into the whirlpool. You try to swim away, but the whirlpool builds and builds in strength and the longer you swim the more tired you get. Eventually you are exhausted and feel you have to give in to it. **That is what it is like.***

*Another way to think about it is being at a silent disco. You are enjoying your chosen track on your headset and can sing along to it in the silence even if you remove your headphones. But then the DJ turns the sound right up on another track. Your brain just cannot stay on your tune. Quickly you relent and sing along with everyone else in the crowd. **That is what it is like.***

Source: VT Holland Advisors Equity Fund December 2023 Investor letter

## Sea change

When we consider what excesses must be purged as this cycle now ends, we need to be mindful of how powerful it was and how many people were sucked into it. This includes central bankers and regulators not just market participants. Only by doing so might we get an idea of what is to come. Some of these past excesses have already been washed out of equity markets. As the best mark to market asset class and a discounter of the future, equity prices were quick to react. However, less readily quoted assets like Private Equity and Real Estate may take much longer to have cheap money excesses purged. On this point we think the views expressed by Howard Marks and his team in the podcasts below very interesting. Also, a recent FT article by Gillian Tett made similar observations about trouble that could be brewing in the Life Insurance sector. Both authors make an important point. This being that the private (off market) funding done in these sectors has grown to an enormous size vs its past. Real estate investors/funders can convince themselves they will be holding an asset for the long term, but if interest rates stay elevated refinancing and valuations could get very difficult. Particularly when old cheap funding is replaced by new funding at maybe double the rate. As Charlie Munger said last weekend, in such periods *“the assets remain the same, but the ownership changes!”* There will likely be plenty of ‘extend and pretend’, but ultimately lenders may end up owning assets they don’t want, which they will sell, reducing prices etc.

- [Howard Marks Sea Change podcast](#)
- [Oaktree Credit Insights Podcast](#)
- [Gillen Tett on Life insurance problems to come](#)

*“The ingredients are there for a very large, multi-asset global episode.”*

Source: Howard Marks May 2023

### Penny Drops and Time Bombs...?

**We thus conclude that the tightening of credit and its work through in certain parts of banking, asset backed finance, real estate and life insurance might have a way to go yet.** As Howard Marks says, this is *Sea Change* moment. As such it will take time for us to see all those that were swimming naked!

- A sector such as Life Insurance we have little expertise in. However, even we could clearly see in the last decade such industries were forced buyers of long bonds at all prices no matter how low yields were. Our understanding is this was due to regulatory requirements.
- The LDI crisis that the UK experienced in late 2022 gives an insight into how group think among asset allocators caused tail risks to be ignored. When we reflect on the asset allocators we have met in recent years, we are sad to report that herd mentality/group think behaviour was rampant. All accepted/assumed low-interest rates and many were all-in on ESG investing. This reflection tells us to expect trouble.
- Sectors like off-market Asset Backed Finance we do not know either. We suspect the troubles here might be similar though. For now, all such asset owners will state that they are to be held for the ‘long term.’ As per recently troubled banks with their ‘Hold to Maturity’ T-bills! Hopefully, a great many projects were financed with long-term fixed-rate loans. Not all will be, and if they were someone would have to take the other side of that fixed/variable rate swap. If we are concluding above that the world might end up with long term interest rates in a 3-5% range, rather than 0-2% range there will be implications further down the line. As fixed rate loan roll-offs become visible a few years out, asset values will need to change to reflect a new high funding cost reality. Many knock-on implications could follow.
  - As a young investor it took a while to understand the relationship between price and yield in the bond market, but eventually it sunk in. The value of a bond with a 6% yield is c.17% less than one with a 5% yield. When the yield move is from 3% to 6% the capital value movement is 50%!!
  - If you think you can open our eyes a little more in any of these sectors, we would be very interested to know what we are missing.

### **Buffett/Munger on real estate**

*“I once asked Charlie, how do they decide how much a building like this is worth?*

*The answer was: whatever they can borrow without signing their name” (i.e. using non-recourse debt)*

*“If you look at real estate generally this phenomenon has been happening. To understand it, you need to remind yourself that this is the attitude of most people that have become big in the real estate business”.*

*“It all has consequences, and we are starting to see the effect on people that borrowed at 2 ½ % and find out its doesn’t work at current rates.”*

**Source: Warren Buffett, Berkshire Hathaway AGM, May 2023**

### **Regulation + Eat the rich**

*“Former bank of England deputy governor Paul Tucker has called for lenders to keep enough collateral with central banks to cover all their short-term deposits in single day. His proposals merit further study. If regulators think midsize lenders are significant enough to warrant more deposit protection, then they should face the same scrutiny that large banks face. This means stronger capital and liquidity buffers and broader stress tests”* **Source: FT Editorial piece May 11<sup>th</sup> 2023**

*“When interest rates rise, this treatment masks losses on banks AFS (Available for Sale) investments, making their capital position look stronger than it really is,” explains Bair, who argued for the US to follow the global approach and force banks to recognise losses on the AFS bonds in real time. Source: Shelia Bair, Head of US FDIC/FT article May 15<sup>th</sup> 2023*

The 2003-7 boom that preceded the GFC in 2008-9 was arguably made worse by value at risk (VAR) type regulations that allowed banks to take on more risk than was realised at the time. The regulatory changes that followed altered this approach, addressing the just experienced short comings. They were knee jerk and did little to aid a credit recovery.

*“The incentives in banking regulation are so messed up and so many people have an interest in them being messed up that its totally crazy. Warren Buffet, Berkshire Hathaway AGM, May 2023.*

Post SVB/First Republic we are very likely to see numerous regulatory changes that again will reflect events just occurred. Our best guess on one of these includes hold to maturity assets for smaller/mid-size banks needing to be marked to market in regulatory capital, as per Shelia Bair’s comments. As we watch end of cycle type events unfold in banking, insurance and asset backed financing it would be wise to expect similar regulatory follow-ups/ knee jerk reactions:

- These will ignore any fault of regulations past.
- They will prioritise system and institutional integrity and unit holder safety. There will be scant regard for shareholder equity as Credit Suisse investors found out.
- They will seek to require improved equity backing at the first sign of trouble, irrespective of the scale of dilution.

In an environment of social media and short seller reports with a ‘fire first’, sometimes aiming only later *could* mean permanent diminution of shareholder value in some companies if a dilutive event is forced to occur. We were mindful of these interconnected risks when we wrote our most recent piece on Schwab. We still think Schwab has a wonderful customer proposition that deserves to succeed longer term. However, that the company is structured as a bank is a statement of fact. This structure creates much complexity as we have written about in our piece. The knock-on impact and interconnection of tougher regulation, changing capital needs, interest rate changes and speculator activities in such a company is hard to look past. This is despite our long-term admiration for its business model. This new Schwab piece can be seen [here](#).

*“When the facts change, I change my mind, what do you do sir?” Keynes*

## Recession or Wealth transfer

Whether the sharp rise in interest rates creates a technical US/EU recession or not, we are less interested in. It would be surprising if they did not. The more interesting debate for us is whether any downturn is deep enough for a dramatic U-turn in interest rate policy to occur, thus meaning our long term 3-5% interest rate world does not occur. Instead a 0-2% one re-emerges. On this we will just state that we don’t know. It is notable how during the UK credit market wobbles in late 2022 and the SVB deposit run crisis that emerged earlier this year the largest UK + US banks looked largely unaffected. Additionally, whilst equity markets have fallen, many of the largest global equity index constituents are high margin, low debt companies. Seen in this light, central bankers do not have a spiralling of loan impairments/collapsing value of investor wealth to worry about as they did in past crises (1990/2001/2008). Clearly that situation can change, but if such a spiral does not emerge, how might this cycle evolve if not in a deep and widespread recession?

Our answer is that maybe a re-transfer of wealth occurs. The 2009-2021 low interest rate period was one where savers were punished, and borrowers rewarded. Said another way those prudent with their finances (be they individuals or institutions) made less money, while those who took on risk and borrowed, made out like bandits. The coming period could see that reverse. If it can occur without leading to a collapse in business/financial market confidence, then we would expect central banks to let it run its course – fully. As per our Dodge City analogy at the start of this piece, there is a time when you cannot restore law and order and time when you can. Well capitalised banks, almost full employment, and big companies unaffected by the need for finance (Apple/Amazon/Facebook/Berkshire) suggest that moment might have arrived. If so, anyone invested in a leveraged vehicle that might need an equity injection should expect to get their cheque books out. Regulators, short-sellers and lenders won't care about long term business models or the NPV of your 30-year project. They will only care that today's equity is too low vs asset values or interest costs. Few voters, or politicians are going to lose sleep over a greedy Endowment or Wealth fund that miscalculated the future, so needing to stump up more equity. Our observation earlier about much asset backed financing now being 'off-market' is interesting. Might some of the dilution pain that is coming happen in private? If so, its contagion will be less damaging for markets and in turn economies.

## Absolute vs Relative investors

*“Do interest rates of 1% or 4% make you think that differently about investing in Microsoft, Amazon or Ryan Air? If you were reaching for yield, by just comparing stock PE's with super low yielding bonds, maybe it does. But that just shows the error of your investment approach nothing more. Absolute return focused investors do/did not think like that. As a result, few have won popularity contests in recent years!”*

**Source: Holland Views: Rejoicing as law and order is restored**

As equity investors we had a ring side seat as ever lower bond yields changed the valuation metrics the **vast majority** of investors used to assess our investment market. Low interest rates convinced many to pay any price for growth. It also saw asset backed securities re-priced off of low interest rates time and again. Whilst a great many highly intelligent people convinced themselves this was both wise and logical, arguably it was just a mass 'reach for yield' exercise. The scale of which markets have never seen before.

*Very low interest rates “distort savings. It causes people to go and reach for growth, for yields as if they were on their hands and knees with a flashlight looking under their furniture for some return on their savings”*

**Source: Jim Grant May 2023**

Consultants, benchmarks, and career risk will all have played their part in this phenomenon, in the same way there were many psychological building blocks that helped create the pre-2008 boom. The reality is that the vast majority of investors in all asset classes (we will guesstimate **over 80%**) were thinking relative in their assessment of returns – **not absolute**. This was always a recipe for trouble. The hamster wheel of relative performance drove a need to comply with the accepted wisdom that said low interest rates justified higher asset prices and more leverage.

*“The most dangerous activity in finance is the reach for yield”.*

**Paraphrase from Seth Klarman, Margin of Safety**



### [Was there any other way?](#)

We believe there was. As per the extract above from our October piece, absolute return investors do not think in this (relative) way. They (we) assess each company for its potential future absolute compound growth and compare it to the price we have to pay today for that growth. We are always trying to not overpay at the point of purchase so that we have a margin of safety in our cost price vs the absolute compounding we hope to get. This is not rocket science, but it does mean:

- a) You need to be able to value a company independently of its market quote.
- b) If your assessment of a company's growth vs the value offered gives you a different assessment to others you have to be prepared to have a very different portfolio from other investors.

In the normal flux of stock market returns such a different portfolio is acceptable and it might lead to a few years of divergent performance. However, if that divergence lasts for a decade, it looks a lot like failure! This is the manner with which many good investors saw themselves with little choice but to give in to the power of the whirlpool. Peer pressure, career risk and social proof were almost impossible forces to resist. Whilst all readers have seen this first hand in equity markets, we have little doubt it was also occurring at a similarly frenetic rate in other interest rate benchmarked asset classes also. The unwind of this is what we are now seeing. We welcome the return to normality that the changing interest rate environment brings. We suspect both higher rates and the knock-on impact of them, might be longer lasting than some today believe.

Many commentators discuss investing in terms of value vs growth. However with 'growth' being a component of 'value' we have always seen this contrast as folly. More interesting to us was the markets obsession with relative benchmarking/relative performance for a protracted period. This tail chasing was self-perpetuating for a while. As more money flowed into 'growth' funds, more AUM bought 'growth' stocks, aka they went up! We are truly delighted to see this madness stop. Whilst we are mindful of risks that might pop up in leveraged business models as discussed here our mantra of looking for great, owner run companies when they are priced like bad ones remains. Our assessment of value and the growth we get for that value has always been absolute, never relative. After all, it is not easy to provide for your pension, or pay school fees with 'relative' wealth!

## Credit Crunch – Part 5

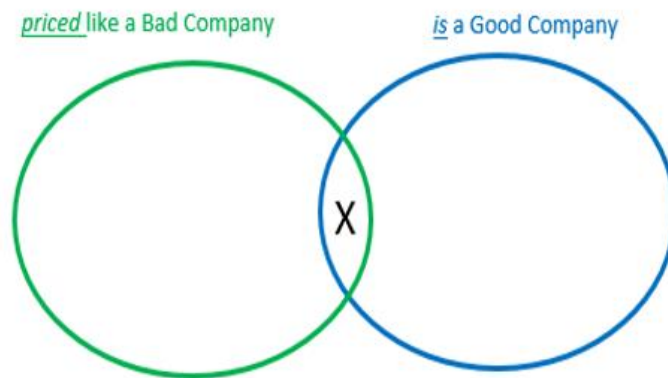
Very long-standing readers/clients will know of the work we did on the eve of the last credit crunch in March 2007. These Credit Crunch pieces (parts 1-4) are all on our website. Indeed, we could have called this piece Credit Crunch part 5, but so few would understand why! After all these pieces were 15 years ago. This was the last time such credit questions needed to be asked. An under-reported fact is that in the period prior to the last credit crunch there were warning signs and people that raised the issue early. We are proud to be on that list. Notably two others that also did so were Jim Grant and Howards Marks – both quoted in this piece! The scale and knock-on effect of what is to come is of course hard to see, but a degree of caution in certain, credit affected, investing areas is wise we suggest.

The wider ramifications of normalised longer term interest rates will also have implications for government spending and the policies/politicians that result. We discussed some reflections in this area in our *Holland Views: Rejoicing as law and order is restored* piece. There will be many more repercussions we suspect as all parties reflect on the end of a 15 year 'free money' period.

We are not optimistic about credit, but we are on the hand we hold

A final point we make is on our optimism for the future. This is not just about some share price mispricings we see in markets today (we do), but also due to the rarity of our/our readers skillsets. We are not saying we expect investing to suddenly become ‘easy’, but it might be ‘less-hard’ than it has felt in recent years. By that we mean the process of working hard to understand the real drivers of absolute compounding only to watch other investors take no notice and instead buy the new shiny growth share was tiring. If we are right and the majority of investors in the last decade have chased market momentum, then they don’t have the skill sets that we at Holland, or you our clients/readers have. **That is good news.** Whether we can profitably use those skillsets to our advantage remains to be seen, but it feels like we might have better cards in our hands today than Mr Market does. It has not felt that way for many years.

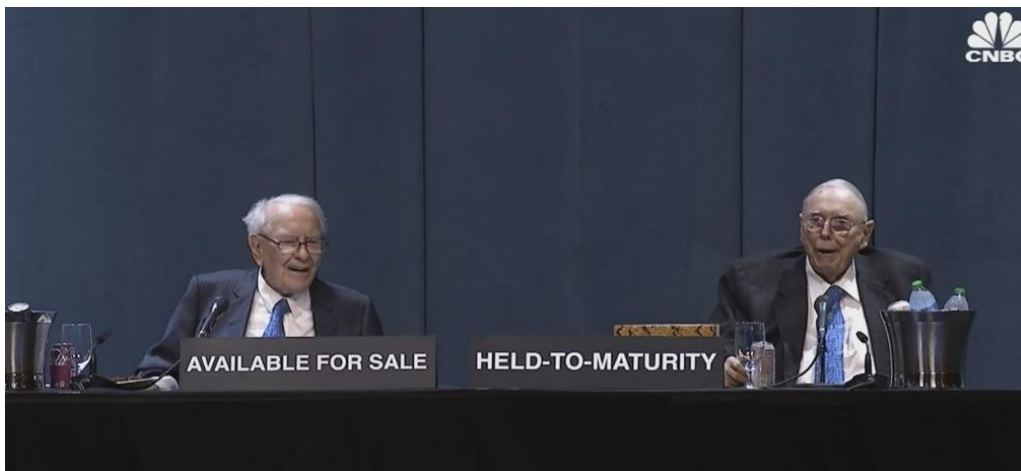
Fig.1 Holland’s modus operandi – Buy great companies when they are priced like bad ones



Source: Holland Advisors

Postscript from Omaha: ROE vs ROCE

Sadly your author was unable to travel to Omaha this year. He has however listened intently to the webcast of the meeting. Those readers wanting to improve their thinking about ‘Returns’ we think could do worse than note the number of times the Berkshire team mentioned “Return on Equity” vs the times they mentioned any other return metric (ROCE/ROIC). The tally reads like a Man City vs Leeds score line! Our focus on absolute returns and ROE has excellent foundations.



Source: CNBC, Berkshire Hathaway AGM, May 2023

With kind regards

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