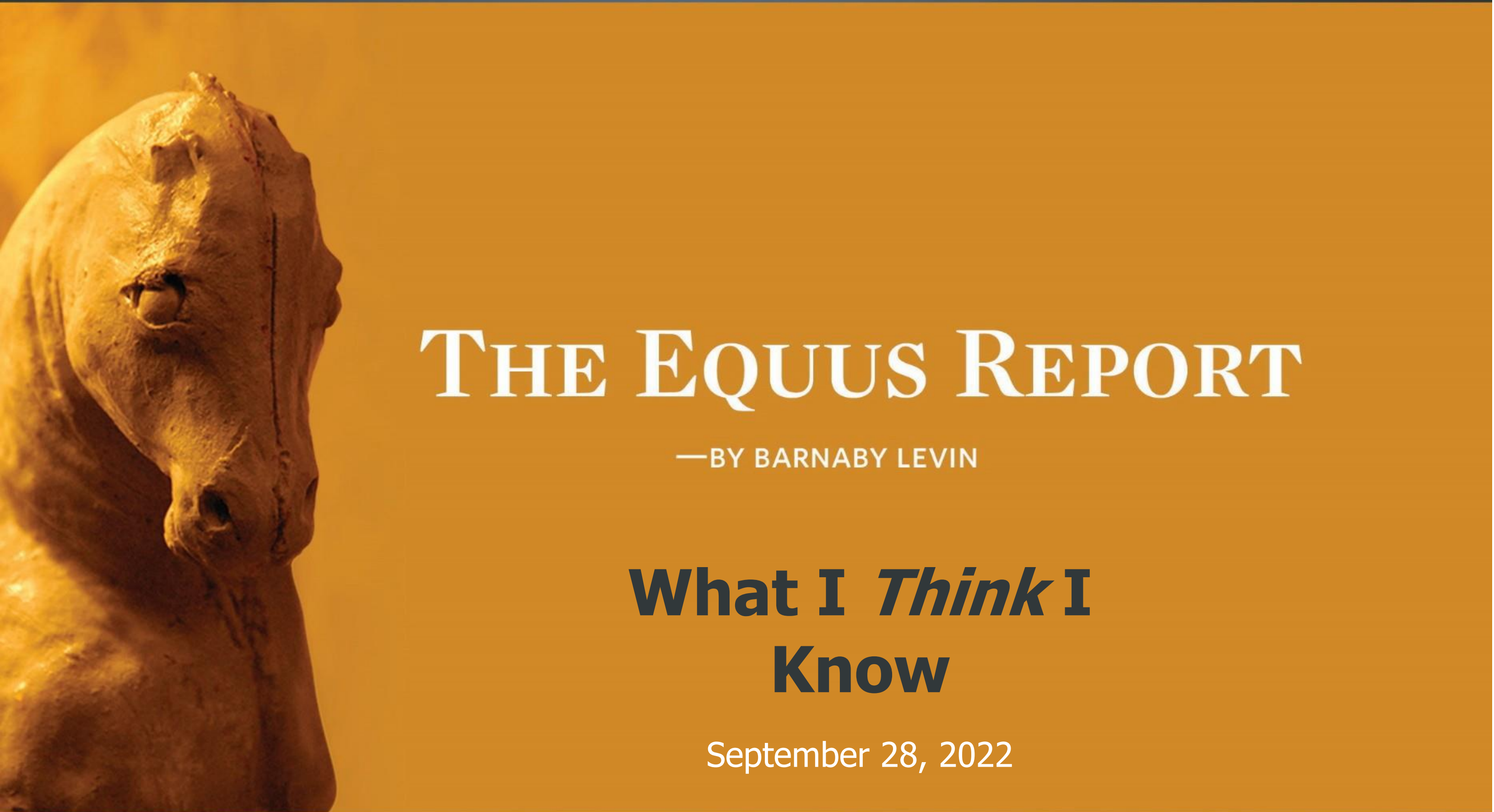
THE EQUUS REPORT
—BY BARNABY LEVIN
What I *Think* I Know
September 28, 2022

It's funny. I was just sitting down to write this – with some thoughts on the future – when I read "The Illusion of Knowledge" by Howard Marks at Oaktree Capital.

Like Warren Buffett and Charlie Munger, Howard has long expressed his (utter) disregard for people thinking they're capable of making forecasts – that is, of thinking they have a (snowball's) chance in hell, except out of (pure dumb) luck. But this was his best explanation ***why*** so, for those willing, I'd recommend reading it[1] and (in the meantime) I'll echo and borrow as needed.

Throughout his letter, Howard sprinkles quotes from people I've long admired, including:

"There are two kinds of forecasters: those who don't know, and those who don't know they don't know."

- John Kenneth Galbraith

"Forecasts create the mirage that the future is knowable."

- Peter Bernstein

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

- Mark Twain

In fact, at one point or another over the years, I've referenced these same quotes in one or more of my Reports – and, in some ways, they provided inspiration for my new, **Plutonomix Podcast** (with Laurie Kamhi) when (in the Introduction) I say:

*"Knowing there are no disinterested parties or un-biased opinions (and that 'where you Sit depends on where you Stand') the challenge to making good decisions is to start by questioning one's **assumptions** and to break free of our prejudices – because the truth usually lies somewhere in between.*

*There are **always** two sides to every issue, **both** of which have merit."*

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[1] "The Illusion of Knowledge," Howard Marks, Oaktree Capital Management, L.P. September 8, 2022

One of Howard's main points is "Forecasters have no choice but to base their judgements on models" – and "Models (by definition, he says) consist of assumptions." To support this, he lists the words investors should (*never* ;-) utter,[2] pointing out how (unlike ***physics***, where electrons *always* do what they're supposed to) people have **feelings**. They get sick; go on strike; and (in today's "Remote Work" and "Work from Home" environment) "quiet quit." On the other hand, electrons don't innovate; create companies and (thereby) thousands or (even) ***hundreds*** of thousands of jobs. Or buck "herd mentality." But ***because*** of this – because people's behavior can (for better or worse) be ***un***predictable – how can the workings of such a massively complex economy as ours be "modeled"? Is it possible (for example) for a model to anticipate a person's decision to pay a premium, simply for the prestige of a thing? Or for an entrepreneur's decision to lose money (for a time) by pricing something below cost to gain market share? Or (influenced by emotion) how one might behave one way one moment and different another, based on whatever's going on in their life at the time? I wish I could say I was impervious to this myself.

Another thing I found interesting falls under the notion of "Where you **Sit** depends on where you **Stand**" – when he talks about something called "cognitive dissonance." "When people are confronted with new evidence that calls into question their pre-existing position, unconscious mechanisms enable them to justify and uphold those positions." The point (when this happens) is people must either admit they're wrong (which isn't easy) or ***reject*** the new evidence and do all they can to justify their position even more vehemently (like "Shaggy's" song, *Say It Wasn't You!*).

Unfortunately, more-often than not (or than most people like to admit), people go with denial. Self-**interest** (whether it's for ***other*** people's "good" or not) simply causes them to act a certain way – and self-***justification*** allows them to stick with their position in the face of (even overwhelming) evidence to the contrary. Even in the worst of times, most bankers and money managers (for example) will remain too optimistic about the future – perhaps because it's better for business to be positive and (if they're ever wrong) they blame their mistakes on being "blindsided" by "random" events "nobody" saw coming – like Covid or the invasion of Ukraine. Whatever the reason – whether they realize it or not – their optimism or pessimism shapes their forecasts and behavior and (to be fair) ***economists*** aren't any better (Howard, in fact, calls them

[2] never, always, forever, can't, won't, will, must

"portfolio managers who never mark to market"). They make their forecasts; are either right or wrong; and, either way, they go on to make new forecasts (at another company or, if they're in Media, channel perhaps) and nobody seems to hold them ***accountable*** as they do their money manager, who people fire if they're wrong too often.

But that's the point. It's always someone ***else***'s future that's at stake (if these "Talking Heads" are wrong); someone ***else***'s money (when it comes to raising taxes to pay for a program ***they*** want); someone ***else***'s job (when it comes to increased unemployment as an "unfortunate consequence" of the Fed raising rates, theoretically to reduce inflation); or someone ***else***'s safety (when it comes to defunding the police, as long as they have their own bodyguards and it isn't ***them*** getting "doxed"). But the moment it affects ***them***? I dare ***any***one to picket outside ***their*** home and hear what they have to say about it.

So, what impact does all this have on ***investing***?

The title of this Report is "What I think I know" – and Howard Marks might say for me ***even*** to ***suggest*** I might have any answers is simply hubris and part of the battle between the schools of "I know" and "I don't know." Those who think they "know" may think they're smart and they'll always sound so confident (*saepe in errore versans, numquam animi pendens*)[3] about whatever it is they have to say – while those who ***don't*** know," tend (as Howard says) to believe "you can't know the future – but (then) you don't ***have*** to." All one needs (they say) is for people to spread their bets so their bases are "covered" (although, he jokes – after a while – "even ***relatives*** may stop asking where you think the market's going" or having you over for dinner!)

As for myself? As you might guess, I'm in the middle. I think one ***must*** have a Point of View – but not so extreme it keeps you stuck in your beliefs. One must ***always*** be questioning – both oneself and one's assumptions – and, as time goes on and things change, modify their approach. I'm always recommending people approach any, important decision based on a thorough examination of everything you can think of (in what I often refer to as a "Ben Franklin Close"), where you draw a line down the middle of a page and, on one side, write down every reason a given choice is "good" and, on the other, every reason why it isn't. And (rather than shunning Macro forecasts

[3] "often wrong, never in doubt"

altogether) I ***do*** believe in focusing ***more*** on the "Micro" – that is, the given industry; company; bond; or alternative manager. I believe – if you do your due diligence and consider everything you can think of, from every angle you can at any point in time – you increase the odds of making the "right" choice (for you) and, even if a given choice goes "wrong," you won't be filled with regret because you know you did all you could.

But as I also say, "less is more," whether it's about government or diversification. When you find a company that checks all the boxes – in which you have the utmost confidence in their addressable market; their innovation and market share; and their management – buy a meaningful amount so it makes a difference. Focus on things regarding which you have a proven expertise and leave everything (where you don't) to someone who does, like I do when it comes to Taxes; Estate Planning; and most "Alternative Investments, like Hedge Funds.

But here's what "I ***think*** I know" – about some of the things on most people's minds these days – and the impact I believe they'll have on the markets.

First, what's more important: the Fed or the mid-term elections?

Because inflation is a monetary phenomenon – based primarily on Supply & Demand; the amount of money in the system; and the Market (therefore) ***will*** (ultimately) take care of itself – I think it's the ***election***.

Regardless of what (most) people (seem to) think to the contrary, the Fed's tools are too few; too blunt; and take too long to work their way through the economy – at least when it comes to ***Inflation***. Whatever "good" them raising rates might do to trigger "Demand Destruction" – as with a lot of drugs, there's simply too many side-effects that can be worse than whatever it is they're trying to cure. The Fed can affect the ***economy***, of course – if they go too far (like they did a year ago, by keeping rates too low for too long) and taking too long to begin their Balance Sheet run-off, when they had ***so*** many chances (like December 20***15*** when, at a SIEPR conference, I asked Lael Brainard why they weren't doing ***anything*** to reverse course, at least to unwind their Balance Sheet). In my opinion, they're on the verge of making the ***same*** mistake again, in the opposite extreme. They're paying a record high interest-rate; on a record amount of money, held at the Fed on behalf of our commercial banks and money

market funds; to store their cash in a risk-free, government-guaranteed account, giving them every reason ***not*** to lend. It's worse than when the government was paying people NOT to work! And the question, as Joe Kiernan asked Judy Shelton (author of *Money Meltdown: Restoring Order to the Global Currency System)* on CNBC[4]: are they ***truly*** so ***determined*** (in their effort to restore their ***own***, sullied reputation) they'll be willing to **kill** the patient in the process? Like Shelton said, it's like something out of Medieval times, when "doctors" ***bled*** a patient to rid the body of sickness. At the very time we're trying to coax people back to work on a full-time basis, the Fed's doing everything ***they*** can to ***increase*** **Unemployment**! Instead of paying banks ***not*** to lend, they should step back (now) and allow the Market to compensate people for investing – so they and their banks will put money to work in projects which (while inherently risky) offer the potential of substantially higher returns in the future. ***That's*** how you raise the Standard of Living and increase Prosperity. And as for the Dollar's strength, by raising rates far higher than those offered overseas, we're "encouraging" foreign Bankers to move their money here – ***not*** to invest, but to get a higher rate of interest which (as Shelton says) is "fickle" money that will flee at the first excuse because we're forcing them to keep pace with us, which they don't like. And, as the $USD gets more out of sync with other currencies – because so much foreign debt is denominated in dollars – we're actually raising the risk of a Regional default somewhere in the world and (before we know it) the Fed could be forced (once more) to ramp up their Currency Swaps (into the $***Trillions***), like they did in 2008 and 2009, so Central Bankers can bypass the Foreign Exchange Market altogether.

In the ***meantime***, the Market will continue to whipsaw (for a little longer, at least), hanging on their every word because the ***Fed*** believes ***they're*** in charge – and ***we*** want to believe there's some Guiding Principle at work. So, people will ***continue*** to be obsessed with those 12 individuals, none (since Richard Fisher) who've ever run a company themselves, sitting around a table talking about "Dot Plots" until we see just how far they're (***actually***) willing to go, to stem the inflation they helped create.

As I said, it's possible they'll go too far and (in my opinion), they should stop ***now*** (at 3 ½% at most) because of:

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[4] "Squawk Box," CNBC, September 27, 2022

- The unprecedented, **rapid ramp** in the Fed Funds rate, from 0.25 to 3.25%, in less than six months;
- The six to **nine-month Lag** before today's rate will be reflected in the economy;
- The strong **correlation**[5] (with a 13-month lag) between Core CPI and the **M2 Money Supply,** which peaked in March 20*21* and, absent any ***new*** Spending Bills (if we simply do *nothing*), inflation should be *back* at *2.49*% by ***next*** June;
- The fact the Fed's "**Quantitative Tightening**" (QT) is only now (as of September) ramping, from $65 to $95 Billion a month;
- Where $35 Billion of ***that*** is **Mortgage-related** and (in part, at least) to blame for the 30-year Fixed spiking (from under 3.0% at the start of the year) to more than ***7.0***% this month; ***and***
- We don't ***know*** what ***other*** impact QT might have on liquidity in ***other*** Markets;
- The degree to which **commodities** (from oil, to copper, to cotton and lumber) **have *already*** fallen (meaningfully) from their respective peaks;
- The slowdown in **Housing** – and in **Consumer Discretionary** spending in general, for everything from clothes to used cars;
- **Consumer Sentiment** now hitting multi-year ***lows***;
- The strength of the **$USD** – and its impact on both trade and the Dollar-denominated debt of foreign countries and companies; and
- The **hit** we've ***already*** taken, year-to-date, to both stocks and bonds

I think the Fed (therefore) should **pause** – to see what happens – before raising more, to give all the above a chance to work, before the global economy really ***is*** driven into Recession (as Stan Druckenmiller and Jeremy Siegel predict, given the Fed's current trajectory) through a self-inflicted, unforced error.

Yet nearly every economist – from John Taylor, to Larry Summers and Ben Bernanke – seems to think they need to keep raising, pedal to the metal, like modern-day Paul Volckers.

I recently had a chance to ask Mr. Bernanke ***why*** (at an Award Ceremony at SIEPR, for his contributions during the Great Recession of 2008)[6] and (looking me in the

[5] Don Luskin, TrendMacro
[6] Ben Bernanke was awarded the "SIEPR Prize" at Stanford University on Friday, September 23, 2022

eye) he said "***Employment."*** They're laser-focused on the impact that and the feared "**Wage-Price Spiral**" ***could*** have on inflation – because ***they*** believe, until people start losing their jobs and Unemployment rises ***substantially***, ***their*** job won't be done!

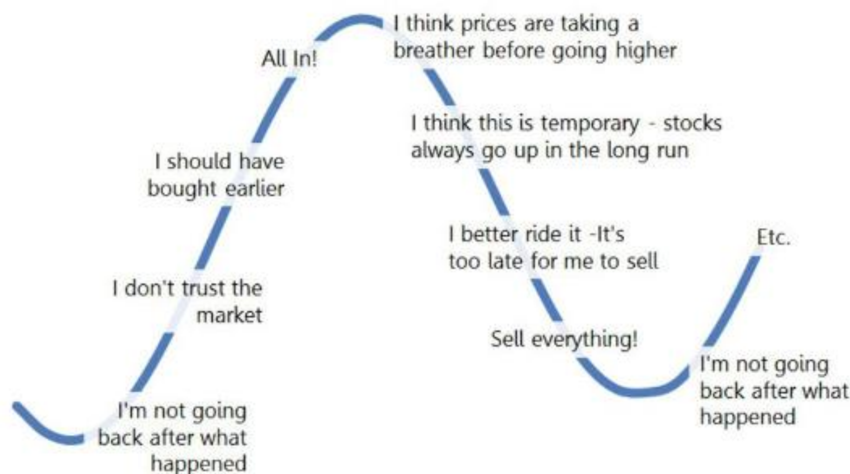
On the other hand …

When it comes to the ***Mid-Terms***, I think it's more clear-cut and "binary." It'll either go one way (the Republicans will win the House) or the other (Democrats will retain control) and we'll know the answer in a few short weeks. I wish (and think it would really help) if at least ***one*** branch of government (the House ***or*** the Senate) could ***always*** be in the hands of the "Opposition," to preserve the checks and balances our Founding Fathers envisioned – both in our Constitution ***and*** Declaration of Independence – and (as a result) when every one of our esteemed politicians so casually quotes "the will of the people," it would truly represent the over***whelming*** majority of the country, forcing our Representatives to compromise, so things don't veer too far from "Center" and nobody's ***ever*** (completely) satisfied or singled out. If I had my "druthers," every politician or government official with any power to make any, binding decision would be limited to a single, six-year Term so they'd never be subject to any undue influence from any Special Interest Group, giving them five solid years (excluding the first, when they're learning the ropes) "to protect and to serve," with enough time to make a difference. Then (as a "bonus") wouldn't it be great if there were a new requirement that any legislation be targeted and "pure" – void of any Pork Barrel spending, unrelated to the mission at hand and buried in the fine print, to get someone's vote? But there you have it – me using all those words like "always," "never" and "should" (though I ***did*** say "***druthers***" and that it's my ***opinion***, right?!)

Again, one way or the other, after November 8th, I'll breathe a sigh of relief because then (at least) we'll know what to expect, ***politically***, for the next two years.

In the meantime, on an unrelated note, I thought this, too, was of interest – that over the past year, through August, 49% of ***Millennials*** (are likely to have) sold their stock – while only 13% of ***Boomers*** have.

If true, the Millennials have (clearly) been "right" (so, congratulations!) and we'll just have to wait to see if they buy back before the market takes off again. But first, they'll need to reserve for taxes (between 25-35%, for State and Federal, on any gain) and then invest in something better than what they had, just to break even. And ***then*** they'll need to deal with all those emotions we spoke of earlier – from "I'm not going back after what just happened" to "I'm all in" again (rinse & repeat).



When investors don't have a portfolio that matches their tolerance for risk, they make bad ...
[+] PATH FINANCIAL LLC

But they'll need to time things close – to make sure they get back in before one of those big rallies that seem to take (almost) everyone by surprise, but which (historically) account for a meaningful part of the market's, long-term returns. Various studies have found – for the last 40 years – the 10 best days (out of more than 10,000) accounted for almost two-thirds of the market's return and (over the last ***20*** years) ***75***%.[7] Of course, the **opposite** is true as well (that is, if you miss the 10 ***worst*** days) and it works out more-or-less the same if you miss ***both***. But there's "the Rub" – because (as they say) it's (nearly) impossible to time the Market – and most people just figure "you have to be ***in*** it to ***win*** it!"

As for the ***Boomers***? I'm guessing they're just sticking to their Long-Term, Buy-and-Hold Plan that Buffett and Munger have always recommended.

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[7] "Should You Sell Your Stocks When The Market Tanks? The Myth Of Missing The Best 10 Days," Raul Elizalde, Forbes, May 5, 2022