We will be giving some macro economic market updates on a weekly basis. No equity recommendations will be given in this commentary, and we encourage you to contact us if you have questions regarding any observations.

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ASSET MANAGEMENT

Contact us today if you would like to meet about your investment future. *info@macnicol.com*

BEACONS OF THE WEEK

The two main purposes of a Lighthouse are to serve as a navigational aid and to warn ships (Investors) of dangerous areas. It is like a traffic sign on the sea.

Port of Tanjung Kalian, *Muntok, West Bangka Regency, Bangka Belitung Islands, Indonesia*

This lighthouse or tower was built by the Dutch in 1862. The lighthouse stands at 56 meters tall.

Ban Tha Thewawong Light, *Ko Sichang, Thailand*

This lighthouse was built in 2012 and stands at 39 meters tall. The lighthouse has an observation deck for visitors.

**Feel free to send us your photos of Lighthouses to be featured in our weekly market observations. **

Reversing rhetoric

For years large asset managers like Blackrock and Fidelity drove narratives that made them more than asset managers. These asset managers were attempting to drive policy on a global scale. When investors realized these efforts were purposeful, they began to pull their money. The biggest pressure has come from state-run funds who have pulled billions from these large asset managers. This pressure from investors has led to a reversal in rhetoric and policy by these same asset managers.

Numerous U.S. states pulled their funds from these managers to limit what they thought was "woke investing". The issue with this style of investing is it negatively impacted consumers and sometimes discounted investor returns due to ESG scores and other irrelevant statistics.

This pressure has led asset managers, Vanguard, Blackrock, Fidelity, and State Street to pull back on their climate and "woke" investing goals. Some of these managers have pulled out of previous promises leading these U.S. managers to lag behind their European counterparts when it comes to efforts to reduce climate warming.

This report by FinanceMap highlights the holdings of these asset managers in fossil fuel production companies relative to green energy companies. These scores have declined for these U.S. asset managers over the last 18-24 months. This directly correlates with the pushback from investors pulling their money from these managers. Whether climate activists like it or not, asset managers care about one thing, AUM (assets under management).

The best example of this shift comes from statements made by Larry Fink, the CEO of Blackrock. In his 2020 letter to shareholders, he detailed that green investing would present the opportunity of a lifetime, fast forward a few years and he has stepped back on those words claiming green and ESG investing is getting ugly, personal, and political.

While U.S. asset managers have always lagged behind their European competitors, this year, the report shows, U.S. asset managers appear to have pulled back even more on climate pledges, as well as in their engagements with "polluting" companies.

Large U.S. asset managers carrying out ambitious and effective climate stewardship practices relative to best practices have decreased by 45% since 2021 according to FinanceMap.

We have been very clear on our thoughts on green investing and using ESG as an investing guideline as we have detailed it in our publications over the last few years. We will never discount our investors' returns for arbitrary ESG scores that are inconsistent.

We think this push by investors will be long-lasting and a warning to asset managers to toe the line between investing and driving policy. Politics have a time and place, but that place is not in the asset management business.

Home prices across the pond

British home prices fell by the most they have in 14 years in July. Nationwide reported a 0.2% seasonally adjusted home price index for July and a 3.8% decrease over the last year.

Inflation remains elevated in the U.K. relative to the CPI in North America. Many are also forecasting a higher peak rate in Britain to combat inflation. The forecasted peak rate is 6.5% currently. The U.K. housing market is also more interest rate sensitive to the U.S. housing market as most mortgages reset between 2-5 years.

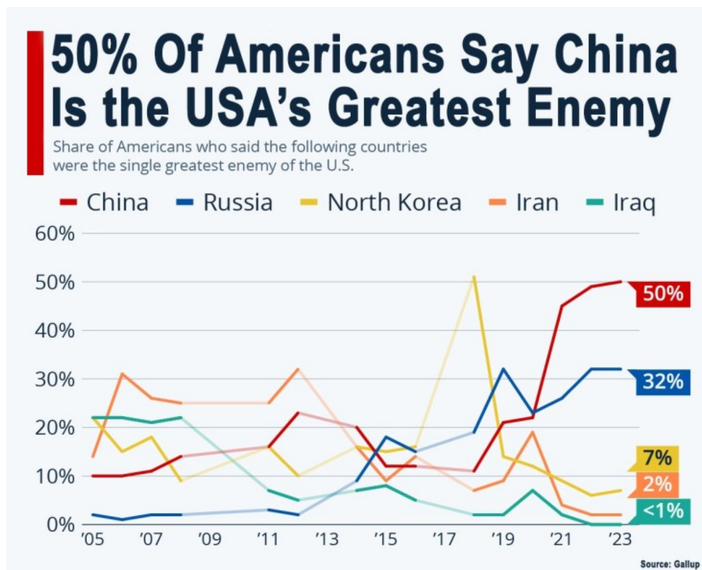
The British CPI is sitting just below 8% as of its last reading:

In June, there were only 86,000 housing transactions in the U.K., a 15% decrease year-over-year. With rising interest rates, mortgage payments are eating into the savings of the British population. Consumers are currently spending 43% of their take-home pay on mortgage payments, well above the long-run average of 29%.

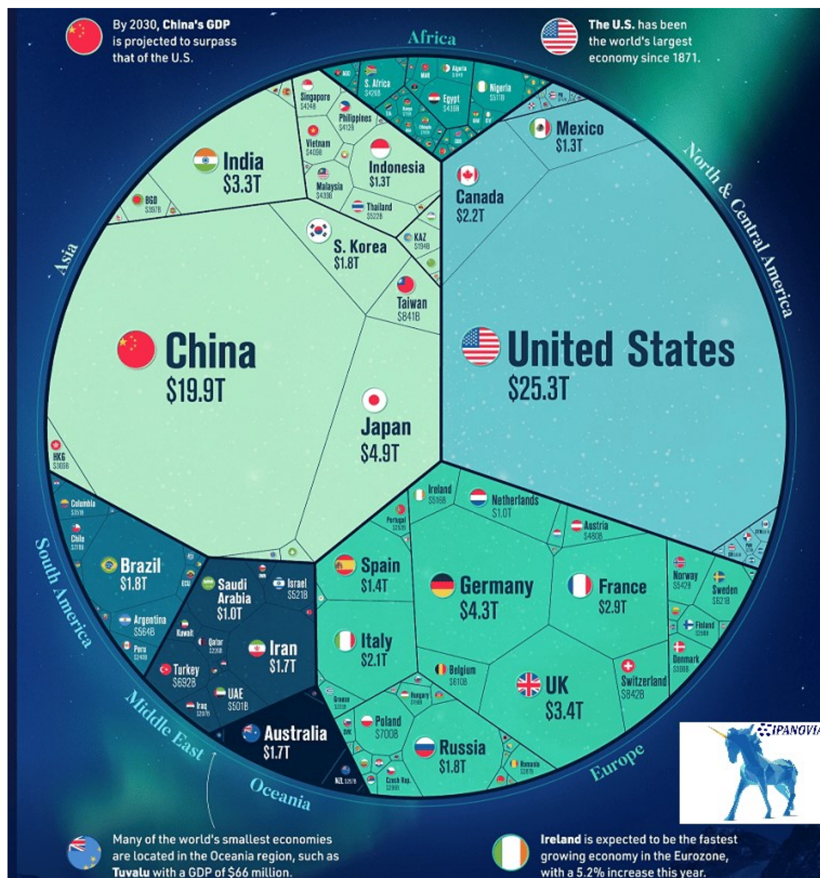
Our focus in real estate remains within North America but we monitor all markets for advantageous opportunities that are deeply undervalued.

Changing sentiment

The sentiment on who Americas biggest enemy is has drastically changed over the last 5 years. 5 years ago, its 2018 President Donald Trump is sparring with North Korea's leader. The attacks were personal, and Trump believed that North Korea was (and still is) incapable of attacking the west in any significant way. At this point, Americans believed North Korea was their greatest enemy or threat and believed the unknown was the greatest threat to their way of life.



Fast forward five years and Americans now believe they have two greater enemies, China, and Russia. Even though Russia is at war with Ukraine and in turn the West, many more Americans understand China is their greater enemy for several reasons. The major reasons China should be seen as a larger threat than Russia moving forward are due to their large population, technological capabilities, and their diverse economy which only the U.S. economy rivals.



The U.S. gets a downgrade

Fitch, a major credit rating agency made a surprising move on Tuesday when they downgraded the U.S. long-term debt rating from 'AAA' to 'AA+'.

This downgrade came completely out of the blue and surprised capital markets participants. This downgrade also comes at an interesting time as economic conditions have improved in the U.S. recently and a resolution to lift the debt ceiling was agreed on.

For those who forget what a credit rating is, a credit rating is an evaluation of the credit risk of a prospective debtor (individual, business, company, government), predicting their ability to pay back the debt, and an implicit forecast of the likelihood of the debtor defaulting.

Here are the major rating agencies and what each rating means.

Moody's		Standard & Poor's		Fitch Ratings		Rating description
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		High grade
Aa2		AA		AA		
Aa3		AA−		AA−		
A1		A+	A-1	A+	F1	Upper medium grade
A2		A		A		
A3	P-2	A−	A-2	A−	F2	
Baa1		BBB+		BBB+		Lower medium grade
Baa2	P-3	BBB		BBB	F3	
Baa3		BBB−	A-3	BBB−		
Ba1	Not Prime	BB+	B	BB+	B	Non-investment grade speculative
Ba2		BB		BB		
Ba3		BB−		BB−		
B1		B+		B+		Highly speculative
B2		B		B		
B3		B−		B−		
Caa1		CCC+	C	CCC+	C	Substantial risks
Caa2		CCC		CCC		
Caa3		CCC−		CCC−		
Ca		CC		CC		Extremely speculative
		C		C		Default imminent
C		RD	D	RD	D	In default
/		SD		D		
/		D		/		

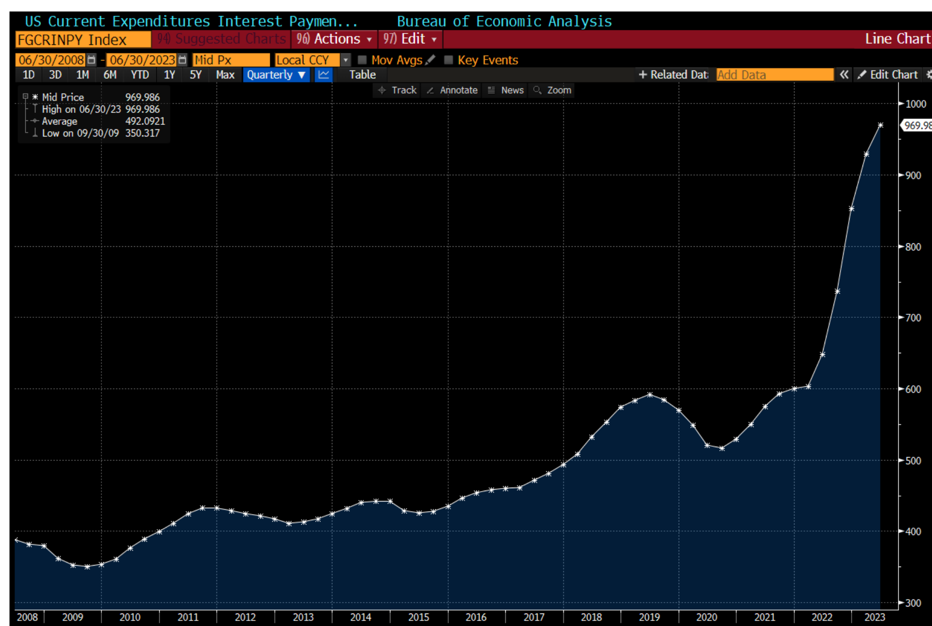
Note Fitch's downgrade of the U.S. government only moves the U.S. from the highest rating to the second-highest rating. It's not like the U.S. government is now on the verge of default.

Fitch's explanation for this downgrade highlights the expected fiscal deterioration over the next 3 years, a high and growing government debt burden, and the erosion of governance. Fitch also mentioned repeated debt limit stand-offs and last-minute resolutions as reasoning for its downgrade moving forward.

Treasury Secretary Janet Yellen fired back at Fitch after this downgrade saying that the move “does not change what Americans, investors, and people all around the world already know: that Treasury securities remain the world’s preeminent safe and liquid asset, and that the American economy is fundamentally strong.”

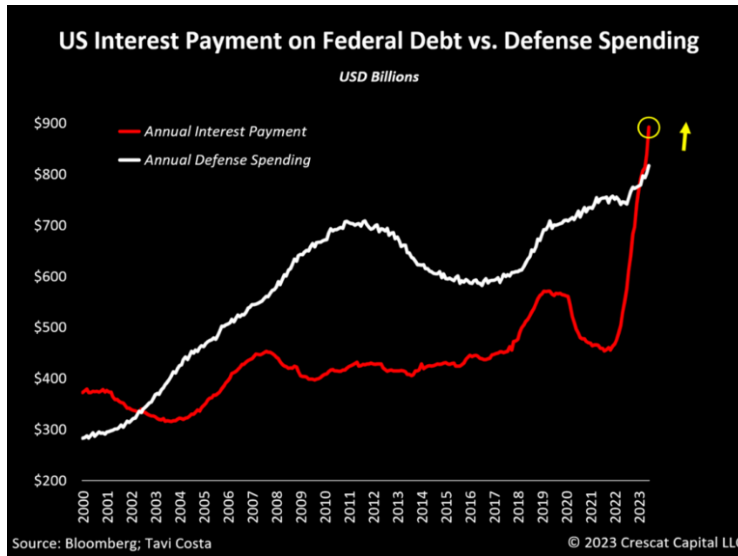
The last time the U.S. government had its credit rating downgraded was in 2011 by S&P Global. S&P Global is an alternate rating agency to Fitch. However, due to Basel bank rules do not expect there to be many forced sellers of U.S. Treasuries. The Basel Bank capital rules group ‘AAA’ to ‘AA-‘ in the same category for risk-weighted assets. This means there will not be many mutual funds, ETFs, or asset managers that will be forced to dump or trim their holdings of U.S. Treasuries.

We think a major driver of this downgrade in rating for the U.S. can be explained in this chart:

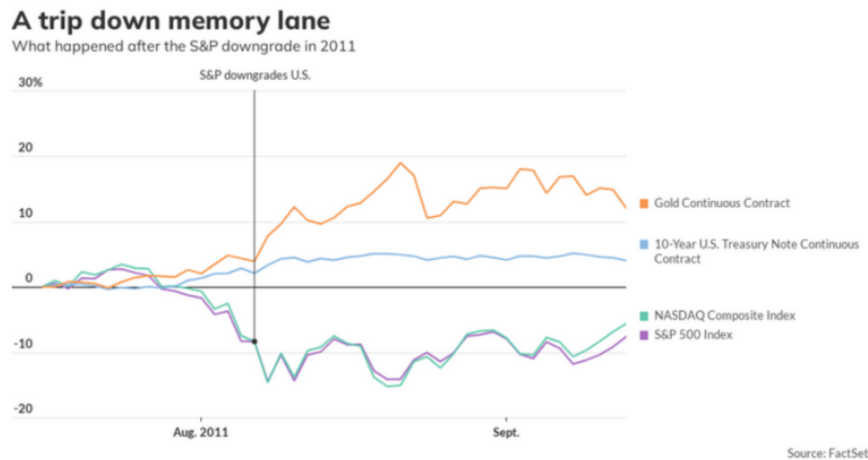


The chart tracks the U.S. government's interest expense which has surged to almost $1 trillion on an annualized basis. This has jumped by almost 50% over the last year due to rising interest rates. As the U.S. government has piled on more debt in recent years, its margin of safety has shrunk – rising rates mean higher servicing costs for their debt which continues to expand. One of the biggest losers of rising interest rates is the federal government.

The recent surge in annual interest payments by the federal government has led to interest costs surpassing defense spending for a fiscal year. This is the first time this has happened since 2001:



After looking at why this downgrade happened and what it means, we wanted to show you a chart from back in 2011, the last time the U.S. credit rating was downgraded. The chart tracks the performance of major asset classes during this period.



Gold might be the asset of choice in the short term after this credit rating downgrade for the world's largest borrower.

We think this event could be a look into the future as more and more government credit ratings begin to deteriorate as interest servicing costs surge.

For your reference here are the highest rated governments in terms of credit quality across the world.

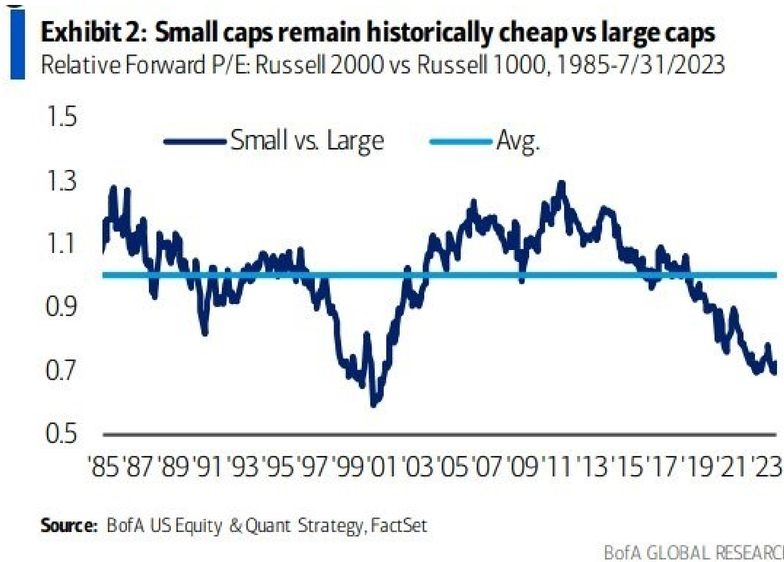
Country/Region	Moody's	S&P	Fitch
Australia	Aaa	AAAu	AAAu
Denmark	Aaau	AAAu	AAA
Germany	Aaau	AAAu	AAAu
Netherlands	Aaau	AAAu	AAAu
Sweden	Aaa	AAAu	AAAu
Norway	Aaa	AAA	AAAu
Singapore	Aaa	AAAu	AAAu
Switzerland	Aaau	AAAu	AAAu
Luxembourg	Aaa	AAA	AAA
Canada	Aaa	AAA	AA+u
Finland	Aa1	AA+	AA+
New Zealand	Aaa	AAA	AA+
Austria	Aa1	AA+	AA+u
United States	Aaa	AA+u	AA+u
Taiwan	Aa3	AA+u	AAu
Macau	Aa3	NR	AAu
Emirate of Abu Dha…	Aa2	AA	AA
France	Aa2u	AAu	AA-u
United Kingdom	Aa3u	AAu	AA-u
Belgium	Aa3	AAu	AA-u

There are now only 10 countries that have an average credit rating of 'AAA', and there are only 9 countries across the world that are graded with a 'AAA' rating for all three rating agencies.

Credit quality matters but there is a razor-slim difference between 'AAA-rated bonds and 'AA+' rated bonds. So, although this may make for some flashy headlines, do not buy the hype, yet.

Small-cap stocks relative to large-cap stocks

According to Bank of America, small-capitalization stocks are trading at a historic low relative to large-cap stocks in terms of P/E ratios. The relative P/E ratio is at its lowest point since before the Dot Com Bubble burst at the turn of the century over 20 years ago.



What happened next was a reversion to the mean and a significant move to the upside that peaked in 2011. During these 10 years, the scales flipped toward small-cap stocks away from large-cap stocks.

We think this trend could repeat yet again after 12 years when large-cap stocks jumped from being cheap to extremely expensive relative to their small-cap counterparts.

A moment for Uber

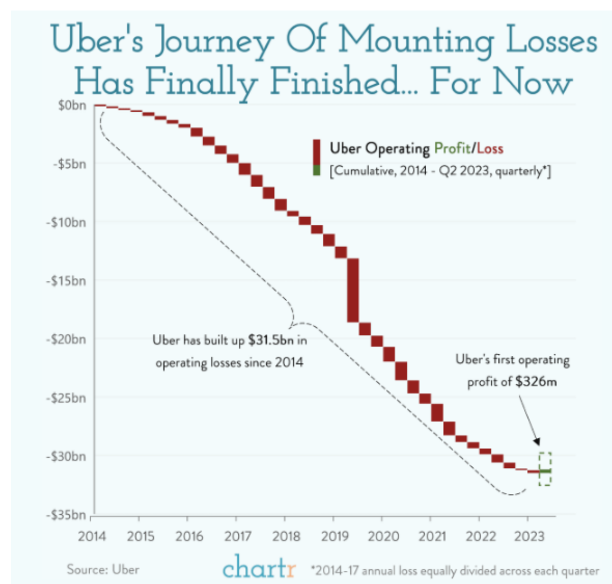
Uber, is one of the stocks that we used in this publication's infancy to describe a company that destroyed shareholder value and burned through cash. In its early days, Uber burned through cash, yes, we know most companies do this, especially unicorns, but continued this trend even when trading on public markets. Uber IPO'd way back in 2019. The company had operated in a loss throughout its private market days and that continued in its public market days. The first quarter that Uber recorded a positive operating profit was the second quarter of this year. Yes, Uber finally reported an operating profit, and they reported that on Tuesday of this week.

After years of dilution, cash burning, and poor forecasting, we are proud to see Uber finally turning the corner to profitability. We appreciate the management team who realized profit and cash flows matter.

Although many technology investors labeled Uber as the future, the market did not reward the company's stock price. Uber shares are only up 12% since their IPO price over 4 years ago.

At the start of this year, they were trading at 50% of their IPO price. Fast forward a few months and Uber shares have surged, and a profit was reported.

Uber reported an operating profit of $326 million last quarter. That number is quite interesting compared to its $95 billion market cap but it's a start. According to Chatr, the company had built up almost $32 billion in operating losses since it was founded.



In total, Uber has raised $25.2 billion with its latest round of fund occurring after its IPO in September 2020.

The company's net income also beat street expectations, coming in at $394 million instead of the projected $49.2 million loss that was expected. A year earlier, they reported a net loss of $2.6 billion. Quite the change 12 months makes. Uber's revenue rose 14% in the 2nd quarter but came in slightly lower than street expectations.

Shares dropped for Uber due to the revenue miss and comments regarding Lyft being a formidable competitor in ride pricing. Uber's CEO also made a comment that he expects Uber to be profitable every quarter moving forward.

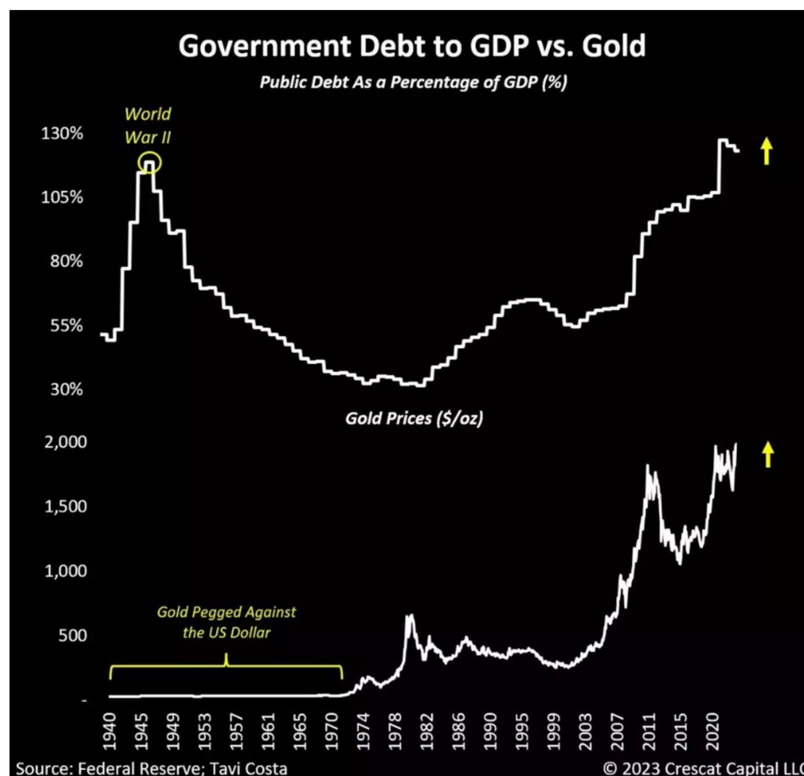
The only issue for Uber might be valuation as even with this profit, Uber trades extremely expensive if you pro-rate these quarter's earnings and sales over a fiscal year. Uber was also able to reach this profitability milestone by cutting costs.

We would still not be buyers at this price but think this is a huge step for Uber moving forward. We also think this milestone could provide some guidance for other technology companies to turn a profit and not just burn cash, and shareholder value on huge growth goals.

Gold's value moving forward

We have been bullish on gold in recent years despite the price of the metal consolidating for what has felt like years. We think gold belongs in all investor's portfolios, especially with the economic conditions that we face today.

We think gold will serve as an escape valve for investors seeking protection from a debt and monetary crisis that governments across the world have created.



We think the debt burden that is present today will lead to investors buying gold over other safe havens like U.S. Treasuries. Even though U.S. Treasuries are seen as the safest asset in the world, they still have counterparty risk which gold does not have. Gold has centuries of credible history and holds physical value even in economic downturns.

We are not saying there will be a circuit breaking that will plummet capital markets but believe the debt burden that we have added on is unsustainable and that something will change. We think gold will outperform most major asset classes in that time reflecting our belief of gold belongs in every investor's portfolio.

Disclaimer: MacNicol & Associates Asset Management holds physical gold, silver, platinum, precious metal equities, and gold ETFs in client accounts.

Enjoy your long weekend.

MacNicol & Associates Asset Management
August 4, 2023