Investment Strategy
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The stock market has remained relatively unchanged over the past quarter while economic data has been mixed in the U.S. and bad overseas. What seems to be shifting are the narratives driving the market and certain important segments of the economy. Narratives are the stories that explain certain events or behaviors. These stories have become increasingly powerful today as ideas can spread instantaneously around the globe. If a specific narrative gains enough traction, it can impact economic activity and lead to misallocated capital (bubbles). During the last economic expansion, "housing prices never decline" was the popular story repeated ad nauseam. Although we know better today, this belief had an enormously powerful influence on consumers, bankers, politicians, and regulators. Ultimately, narratives must reflect reality, or they can reverse in dramatic fashion. Over the past 3-6 months, we believe there were several important shifts in perception which will have ramifications in the foreseeable future. Specifically, the U.S. shale oil revolution and tech-fueled initial public offerings (IPOs) are facing increased skepticism.

Narratives nearly always start with a kernel of truth. It was true that nationwide housing prices had not suffered any significant decline in value during the post-war period (1945-2006). Of course, this truth ignored the housing boom of the 1920s and the subsequent bust which was a major contributing factor leading to the Great Depression. Citizens of real estate-focused South Florida can still find plenty of remnants from this boom and bust today. Despite history proving otherwise, the "housing prices never decline" story was repeated enough times to become ingrained in the American psyche. This led to a chain of poor decisions by nearly all involved parties. While an average citizen trying to realize the American dream may be forgiven, the professional bankers and financiers that handed out loans to anyone with a pulse should have known better. However, that is the power of certain narratives. Some become so overwhelming that naysayers are drowned out and unsuspecting investors lose money.

Several popular narratives today have likely grown beyond their reality. Rather than provide a laundry list, we think it's more important to focus on two areas that could impact the economy and overall stock market. One industry that has probably had the greatest impact on the U.S. economy over the past decade is the shale oil industry. Around the time of the financial crisis, wildcatters in Texas and North Dakota began to perfect a technique to unlock oil trapped in shale rock. Coming out of the recession, the United States' unparalleled capital markets kicked into gear to create an enormous industry within a few short years. This development was critical in supporting the economic recovery as it generated a huge number of high-paying, blue-collar jobs in areas of the country that had largely been left behind economically.

As a result of the shale revolution, U.S. oil production has more than doubled since 2008 and recently passed Russia and Saudi Arabia as the largest oil producing nation in the world at more than 12 million barrels a day. The U.S. is now "energy independent" as oil imports have fallen dramatically. In response, consumers are once again buying extra-large vehicles and policy makers are slowly disengaging from the Middle East. The problem with this triumphant story is that the independent oil companies focused on this opportunity failed to generate any profits over the past decade. In fact, the industry has collectively burned through several hundred billion dollars during this period. Eventually, the reality of an uneconomic activity will confront the rosy picture of U.S. energy independence. Russia and Saudi Arabia conspired back in 2015-2016 to break this disconnect by ramping up production and cratering the price of oil. Unfortunately for them, belief in the shale revolution was still strong and Wall Street rushed to the rescue by providing a new surge of capital into the industry. These investors have now realized this was a mistake.

Throughout 2019, the number of active drilling rigs in the United States has consistently trended downward. Wall Street is demanding that oil companies show profits before supplying any more capital. Thus far, the industry has been able to maintain oil production by simply re-fracking old wells to wring out additional oil while cutting back on new drilling. Despite this unsustainable profit-boosting trick, most firms in the industry have still not been able to report positive cash flows. Without a ramp up in new drilling, U.S. production can fall rather quickly because shale wells produce most of their oil within the first two years of extraction.

To be clear, shale oil will continue to be an important industry in the United States for years to come, but it will be structured differently than today. In the next downturn, there is likely to be rapid consolidation at highly discounted prices. The large companies that remain will exploit the resource more systematically to further trim the cost of production. In the end, U.S. oil production is likely to decline to a more rational level unless oil prices move significantly higher.

If you like exciting narratives, Silicon Valley has a story to sell you. Reminiscent of the late 90s tech bubble, there has been an explosion of tech startups over the past decade. 0% interest rates have made funding easy to attain in the private markets beyond the burden of the extensive disclosure rules associated with a public offering. Many of these private companies have rapidly grown revenues, but few generate any profits. The largest of these tech unicorns have started to become public over the past year which allows the venture capital investors and employees to sell their ownership. Unfortunately for the buying public, the Wall Street Journal recently pointed out that only 3 of the 14 most notable tech IPOs in 2019 are currently trading above their first day price.

Given these dismal returns, investors have become far more skeptical of new initial public offerings. Tech companies that have customarily presented fanciful stories with the promise of large profits in the distant future are having difficulty convincing investors they have a sustainable business model. There is no better example than the recent implosion of WeWork. Disregarding their cult-like marketing, WeWork rents out large commercial spaces, redecorates with hip décor, and subleases that space by the desk. This business model can be profitable during strong economic expansions but is inherently unstable during recessions because most of their desks are rented on a month-to-month basis. In spite of this drawback, WeWork was able to attract more than $12 billion in capital from private investors since 2010 and has rapidly expanded to most major cities around the world. In fact, WeWork is now the largest commercial tenant in New York City!

Although WeWork has been able to roughly double revenues each year for the past few years, the company has generated growing losses as well. Despite raising $2 billion in January that valued the company at $47 billion, WeWork prepared to go public in September to raise additional funds. As part of the process, WeWork was required to make routine disclosures that exposed several issues within the company. As a result, investors rejected the offering and the company's "visionary" CEO has stepped down. Within roughly a month, WeWork went from one of the hottest tech companies coming public to a property management firm that may be bankrupt within a year. The reversal in the WeWork narrative has been breathtaking and spells trouble for other technology companies hoping to go public.

Many narratives in the market today have become overly powerful simply because they have been going on for so long. An unintended consequence of the ultra-low interest rate environment over the past decade is that it has allowed many poor companies with good stories to attract ample funding. As we promised our intern early this summer, it was highly likely WeWork would collapse at some point based on a basic understanding of their business model (although we assumed a recession would be the trigger). While this should have been clear to any rational investor, this company still attracted billions in funding.

A fair interest rate is important for capitalism because it naturally starves out non-economic, loss-making activity. Conversely, there are many questionable business models in operation today thanks to the ease of financing. Our job is to try to avoid these stories and businesses that do not add up. These hollow narratives will eventually confront economic reality and either adapt or struggle mightily. We believe that time is sooner rather than later as investors grow more pessimistic amid all the negative headlines emanating from politics, trade wars, and now a failed tech IPO. As Warren Buffett famously said, "It's only when the tide goes out that you discover who's been swimming naked." We believe the tide is receding and there is a lot left to be exposed. As a result, we continue to reiterate the importance of being very conservative in the current environment with U.S. Treasury bonds and gold as important components of client portfolios.

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