Marble Harbor Investment Counsel, LLC
Fourth Quarter, 2021 Letter

We are pleased to send an excerpt from our fourth quarter client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb, Daniel Rosenblatt and Howie Cowan

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At this point in our lives, most of us have experienced some form of surgery or at least know someone who has. After the procedure, there is the fog of anesthesia, a bit of pain, and perhaps a little loopiness from the medication. In a few days, we may be ready to get on with life, but the body often begs to differ. Every setback feels unexpected and frustrating. Meanwhile, the doctor sees a normal, if meandering, healing process.

In 2020 the world economy was suddenly sedated as COVID-19 raced around the globe and local economies shut down. The second quarter of 2020 saw one of the sharpest contractions in GDP ever. Fast forward and we're now experiencing some of the fastest growth in GDP in the last 50 years. While this economic boom is remarkable, it's not a smooth and easy ride. It is unreasonable to expect that the global economy would awaken from its slumber in a gentle, measured manner and pick up where we left off in March 2020.

For many years, we've enjoyed "The Great Moderation." The economy grew consistently around 2%, inflation was subdued and unemployment steadily dropped. Companies could plan years ahead, adding small increments to capital spending to fulfill steady demand growth. They had elegantly reliable supply chains stretching across the world connecting them with skilled, inexpensive labor that could deliver parts wherever and whenever needed. A whole generation of managers, policy makers and consumers came of age in this predictable environment.

As the world is awakening, increasing demand is creating unanticipated shortages and gluts. Too many ships in the Port of Long Beach, too few truck drivers. Too much natural gas in Ohio, too little in Germany. Huge investments of capital are being made to ease bottlenecks and balance supply chains. Intel is spending $20 billion building new semiconductor factories in Arizona, while Taiwan Semi is spending $100 billion on its own factories over the next three years, including one in Arizona. Establishing shorter supply chains will create a more resilient system, with more redundancy, but it will sacrifice some corporate profitability. For all their new capital spending, investors in Intel and Taiwan Semi will want a return on that capital, which means higher prices on computer chips and the products they go into for you and me. This is how increased capital spending across the economy feeds inflation.

Inflation is sometimes referred to as a lubricant for the economy: Higher wages cause people to spend more. This leads to greater demand that gives the companies (and their suppliers) the confidence to raise prices, leading to more sales, higher profits and even higher wages. We're seeing this now. Your companies can benefit from this virtuous cycle as long as it remains moderate. The shortages that arise are a form of delayed gratification. Rather than being able to satisfy demand immediately, this may serve to lengthen and moderate the post-COVID boom and mute long-term inflation. We may have a longer, more sustainable expansion, which is good for consumers and companies alike.

Roused by inflation, the Fed has said it will raise rates this year as it has been foreshadowing for quite some time. This change in stance has resulted in a swift sell-off in some of the most speculative corners of the stock market. For more than a year, we've been discussing the extreme speculation in the technology sector; there haven't been this many companies so richly valued since the tech bubble in 2000. Some of these businesses don't have earnings today, and they won't for years to come. Investors value them on hoped-for cash flows many years in the future. However, as interest rates rise, the value of a promised dollar in the future is worth less. As we leave the ultra-low-rate environment behind us, a bird in the hand is far more attractive.

With rates starting from such a low level, the stock market itself is much more correlated to changes in interest rates than in most periods, and those same tech companies are the most affected. We have avoided investing in these unprofitable, richly valued companies, as our discipline leads us to profitable, growing enterprises. Although some of these businesses are interesting, valuations have been far too challenging and have made them risky, volatile propositions. If this correction continues, we may be able to find some better businesses at reasonable multiples that reflect both the long-term promise as well as the risks.

Just as the high-flying tech companies remind us of 2000, so too does the Special Purpose Acquisition Company (SPAC) market – an alternate way of going public that avoids the regulatory oversight usually associated with a traditional IPO. The attraction of quick riches in the public market without all those pesky investor safeguards has proven irresistible to management and sponsors alike. There was record SPAC creation in 2021, and a breathtaking number of deals done to take businesses public via this method. The result: A flourishing of creativity in justifying the valuations of many enterprises that couldn't raise capital elsewhere. As might be expected, this has led to many of these stocks being down 40%, 50%, even 99% after their SPAC-driven IPO. The wreckage here seems as if it's in the early stages. There are likely some babies that are being thrown out with the bathwater, but we are proceeding with caution.

As we've discussed over the years, it is to be expected that the speculative corners of the market would get wrung out when interest rates start to rise. The question is never "if," but "when." Fortunately, we can be less concerned with "when," because the profitable, growing companies you own continue to deliver excellent results, albeit with much less challenging valuations. We don't play the greater fool game. Our companies trade on real earnings and cash flow, which are growing nicely in this economic expansion. The return of some rationality is welcome.

Recovering from surgery is never straightforward and always a process. We want our lives to return to the "normal" we knew and our healing to progress in a continuous upward trend. When this does not happen, we find ourselves impatient and exasperated. Similarly, it can be disconcerting to be amidst the fits and starts of the reawakened economy. There is always something going wrong, and the talking heads are more than happy to sensationalize each hiccough and speed bump. Over time, supply chains will mend and inflation, we hope, will moderate. Adding resiliency to supply chains and renewed capital spending in both the U.S. and Europe should help to bolster long-term growth. Cycles of speculation will come and go. With a long-term view, we will ride out this volatility together.

Please don't hesitate to contact us if you have any questions.

Sincerely,

Paul, Eric, LJ, Dan and Howie

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