JANUARY 2023

# JORDI'S JOURNAL

Timely thoughts & musings on the financial markets

## ADAPT OR DIE 3.0: THE ABCS OF MARC ANDREESSEN AND THE END OF MOATS

By Jordi Visser, President & CIO

The last three years have been a wild roller coaster ride for investors. It is difficult to remember every twist, turn and loop de loop that has happened during this adrenaline-filled moment in time. Everyone seems to remember where they were in March 2020 when the world suddenly closed, and we all boarded the roller coaster, but after that, it became an experiential blur. Only now, the caboose of the covid train seems to be finally leaving the tunnel as China nears the end of its zero covid policy. To summarize what occurred on this never-ending ride, there was a global pandemic, a closing of the global economy, a significant stock market fall, massive money printing, a record-timing vaccine delivery, a meaningful stock market recovery, a storming of the Capitol building, multiple covid variants, skyrocketing inflation, unprecedented central bank rate hikes, a stock and bond market collapse, a Russia invasion of Ukraine, and what appears to be the unofficial ending of the pandemic with the end of the zero covid policy. If all of this wasn't enough, just as this three-year ride is ending, the consensus outlook for 2023 includes more pain for stocks and a recession.

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Although some forecast economic doom, the good news is that the consensus recession call seems to be for a mild recession. Since there is no accepted definition of a recession, there is certainly not one for a mild recession. Most stock forecasts expect weakness early in 2023, followed by a rally once earnings revisions reflect the recession risk. Barring an economic collapse, the economy has a low threshold to exceed expectations this year.

I am frequently asked for my definition of a recession. I define it simply as YoY corporate revenue decline and job losses. Because of this, I am in the no-recession camp. I believe the labor shortage and good consumer balance sheets will allow the consumer to spend enough to keep GDP ok and corporate revenue growing. My view is based on no signs of a systemic credit event and confidence that the Fed's path to fight inflation does not include putting people out of work while inflation is trending lower, especially before a Presidential election. Without job losses, a recession is almost impossible since the US consumer has always been a tough short. The rapid rate rise is in the early stages of impacting the economy and, like inflation, the labor market is a lagging indicator, so this may change, but currently, the jobs market shows little to no signs of weakening. Over the last six months, we have created almost 2mm jobs, and we have more job openings than unemployed to fill the positions. These are quotes from the most recent Beige Book:

*"Labor markets were still described as tight" and "some contacts expressed a reluctance to shed workers in light of hiring difficulties, even though their labor needs were diminishing."*

By my calculations, we also still have 1.5t dollars of excess M2 relative to the nominal GDP spend seen since 2019. This is despite M2 posting its first negative YoY growth in 2022 in the last 50 years. One thing I think can be said with certainty is that the US economy will slow sharply in nominal growth terms from the elevated levels in 2022 and earnings growth for companies will be a challenge.

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Without a recession and with declining inflation on the back of slowing growth from high rates and declining money supply, I don't think the story for 2023 will be a similar one to this past year. The story could be earnings. With the recent fall in the dollar, the decline in bottlenecks and freight rates, and an expected pickup in China growth, if we don't see a recession, I think the surprise will be that earnings are able to hold in better than most expectations. Nonetheless, there will be new headwinds for valuations as stocks will lose their TINA* attractiveness which was pervasive during the prior decade of low rates. If stocks are able to move higher, I would not expect an easy rise as those high cash levels are finally getting paid to sit there. With rates at the highest level in over a decade, the current environment for investors has a little bit of a 'Back to the Future' feel where we have been transported to a very different world than the decade post the Great Financial Crisis. Howard Marks, Co-chairman of Oaktree Capital Management, summarized that period well in his recent paper:

*"The overall period from 2009 through 2021 (with the exception of a few months in 2020) was one in which optimism prevailed among investors and worry was minimal. Low inflation allowed central bankers to maintain generous monetary policies. These were golden times for corporations and asset owners thanks to good economic growth, cheap and easily accessible capital, and freedom from distress. This was an asset owner's market and a borrower's market. With the risk-free rate at zero, fear of loss absent, and people eager to make risky investments, it was a frustrating period for lenders and bargain hunters." Howard Marks*

This abrupt change means investors need to be ready for a very different environment in the coming years. Balance sheet analysis will be an important theme in 2023 with rates up here, nominal GDP slowing, and the labor shortage. However, Mark's description of the prior decade did leave out one of the most important events of that period: US technology stocks dominated the alpha generation in investors' portfolios around the globe. In May 2013, I wrote a paper titled "Adapt or Die: An Investment World Driven by QE, Tweets, Clouds, Robots, Singularity, and Luddites."

*There Is No Alternative

The paper focused on exponential technological innovation's impact on traditional economic and investment measures as the convergence of these new technologies would change our lives. Thus, all of us in the investment world would need to Adapt or Die. It is difficult to imagine a world without a smartphone, but that was the case before the US housing market collapse began. The Luddite comment referenced the difficulty for people to adapt to thinking of technology and its impact on the future. This is an excerpt from that paper:

*"The easiest guess for the future is to take today's problems or successes and assume they will continue. In a linear world where technological change happens at a slow enough pace to not be disruptive, it's fairly easy to adjust when things change. In an exponential world, technological change happens quickly and can be very disruptive; it becomes far less predictable and people have difficulty adjusting. Over the last few years, it feels to me like people, companies, governments and markets have been adjusting, or rather adapting, to a world where technology's impact is difficult to comprehend."*

The technological disruption we saw from 2010-2019 before covid led to a period of lower inflation and lower growth with boatloads of QE. Howard Marks does not reference it, but exponential innovation, along with debt and demographics, are some of the forgotten forces that helped drive yields into negative territory beginning in 2014. The investment world was full of rainbows and unicorns with the hope of exponential innovation and disinflationary times. The rainbows had a pot of gold at the end with 15% a year returns in stocks and close to 7% in IG bonds. The unicorns were the private technology companies that disrupted the brick-and-mortar businesses and went public, providing riches to investors. US mega-cap tech companies' market caps grew like the StayPuft marshmallow man in Ghostbusters to quickly surpass most countries' GDP. Their rapid growth allowed them to build moats around their businesses and buy up any potential competitors while attracting the best talent from around the world and effectively centralizing global technological dominance in the US.

Economists and macro investors talk about that decade as dominated by central banks and financial repression because its quantifiable and mathematical, while exponential innovation and its disruption are hard to measure in economic terms. Marc Andreessen had predicted this type of decade in 2011 when he penned the op-ed “Why Software Is Eating the World.” This excerpt from that op-ed inspired me while writing my paper in 2013 related to the economy and inflation:

*“My own theory is that we are in the middle of a dramatic and broad technological and economic shift in which software companies are poised to take over large swathes of the economy…….Many of the winners are Silicon Valley-style entrepreneurial technology companies that are invading and overturning established industry structures. Over the next 10 years, I expect many more industries to be disrupted by software, with new world-beating Silicon Valley companies doing the disruption in more cases than not.”*

Given the dominance of US technology companies, the title could have been “Why US software is eating the world.” After 2022 saw technology become a curse word for investors and Cathie Wood’s innovation ARKK sank, nobody cares about exponential innovation. The current narrative is back on quantifiable macro forces where central bankers matter again. As Howard Marks describes, we are entering this year in a very different environment; But not everything has changed today relative to the environment from the prior decade. There are some forces that are not transitory. The currently forgotten structural forces of debt, demographics, and exponential innovation are still present and even more significant today. They will undoubtedly become stories again soon as growth slows and inflation declines. These forces proved deflationary before the covid driven M2 surge, and now with M2 declining for the first year in 50 years and three-month rates at the highest level since the iPhone was first released, deflation is certainly part of the probability distribution curve in the coming years.

Since economists have no way of embedding exponential innovation into their forecasts on growth and inflation, let’s again look to Marc Andreessen for his world

views on technology going forward. In an interview with McKinsey & Company over the summer, he listed the innovations he thought would be the most important future disruptors. He used the acronym ABC to represent the three main drivers of innovation: Artificial Intelligence, Biotech and Crypto.

2022 was a horrible year for innovation investing, but December was a big month for the ABCs. For crypto, despite the focus on FTX, David Solomon from Goldman Sachs wrote an opinion piece in the Wall St. Journal titled, “Blockchain is Much More than Crypto”. Andreessen had to use crypto for the acronym to work, but here is what he said in the McKinsey interview with regards to Web 3 and the blockchain:

*“I think this is a foundational technology change, a new architecture for building an entirely new generation of computing systems. We have become convinced that Web3/blockchain/crypto is foundational. It’s a big hill. It’s as foundational an architecture shift as the ones from mainframes to PCs, from PCs to web, from web to mobile, or from traditional software to AI. It’s a fundamental shift and building this out is a 25- to 30-year process.”*

December also saw AI and biotech merge with the announcement by Moderna and Merck around the success of their cancer vaccine. Like with the unprecedented speed of the covid vaccine, AI was an instrumental part of the process for the cancer vaccine. This advancement has implications for lifespan and healthspan in the years to come. AI was also part of the process for scientists at Lawrence Livermore National Laboratory to pass a major fusion milestone in December. In these cases, AI acts as an accelerant for solving problems. December also saw the largest jump in AI google search trends as OpenAI released ChatGPT, allowing individuals to experience the power of AI. Daniel Gross, who led Apple’s machine learning department in 2013 at the age of 22, recently wrote about ChatGPT, “The future is finally coming. If the last decade was about software eating the world, the next one is about AI powering the software. We spent a decade building the grid, and we’re about to flip on electricity.” Even current inflationista Larry Summers joined the AI chorus in December saying, “ChatGPT is a development on par with the printing press, electricity and even the wheel and fire.”

Despite all this hoopla, we are still in the early innings of the ABCs and any potentially deflationary impact. AI will help with the labor shortage and should help businesses make better future decisions, keeping costs down and reducing inefficiencies. Biotech will help with the labor shortage by helping lengthen the healthspan, allowing people to work in their later years. The blockchain will help with the labor shortage by displacing the middlemen and allowing those people to find jobs in other parts of the economy. None of these will happen overnight, but it is already showing in the competition for talent. Marc Andreessen highlighted this in his interview:

*"The core thing that we do is track talent flows. And the thing that we know for sure is that the smartest people in the world, the smartest kids graduating from college, and the smartest industry professionals are flooding into those three sectors. There's an incredible wave of talent in the form of top-end engineers, scientists, executives, and founders flooding into those three sectors. In our world, that's not completely predictive, but that's as predictive as you can get."*

As these advancements continue, investors will eventually get excited and try to take out the 2009-2021 playbook and figure out who will make up the new FAAMG in the coming years. This is where I think the disruption lies differently than the last cycle. Facebook, Amazon, Apple, Microsoft, and Google disrupted many companies as software ate the world. They were able to attract the best talent and buy the best companies to build a moat around their businesses. But now, these mega-cap companies are under attack as competition rises fast and disrupts. Three weeks after ChatGPT was released, an article in the NY Times said, "A new wave of chatbots like ChatGPT use artificial intelligence that could reinvent or even replace the traditional internet search engine." If AI can accelerate solving cancer and fusion, the disruption this time is more likely to be technology eating technology companies' future growth certainty and their ability to build moats. Part of the ability to build moats was reaching escape velocity in size. In recent years, we saw what has happened to UBER, WeWork, and the ARKK names. In a world with competition from the ABCs and the growing ability for global competition, I think the ability to pick the winners five years from now will be challenging as the lifespan of a company continues to shrink. It also means the companies with the most bloated market caps and the most to lose from increasing competition and an inability to attract the best talent are the most vulnerable.

Howard Marks is describing the environmental change for investors based on traditional cycle relationships that argue for valuations and balance sheets to be important again. I agree with that view for the coming year. More importantly, portfolio decisions are not just about looking for winners to add but also about looking for losers that could be disrupted. For this year, I believe it is the single most important decision. I would take out the disruption handbook from 2009-2021 and remember the story was not just about investing in Amazon to win but making sure you shorted or got out of the companies it would disrupt. Michael Burry of "The Big Short" fame, who called the housing bubble, has been vocal recently about another bubble worrying him. In an article from October, when talking about equity market risks, he was quoted saying the "Difference between now and 2000 is the passive investing bubble that inflated steadily over the last decade." He was referring to directional equity risk, but I think this is a portfolio construction risk where passive investors are unknowingly in active investments that adjust based on time and relative movements of the underlying pieces. Anyone benchmarked to an index or those who moved into a passive cap-weighted ETFs, should realize if the mega-cap disruptors are about to become the disrupted, they are overweight the disrupted and positioned the wrong way. This goes for SPX investors but also for MSCI benchmarked investors. As Annie Duke said in her recent book, 'Quit: The Power of Knowing When to Walk Away', "Sticking to something that's no longer worthwhile is going to stop you from reaping the benefits that were the original reason for setting the goal in the first place, or it's caused you to incur more costs that you were originally willing to bear."  The world has changed for investors post covid and software may have eaten the world in the period before the pandemic, but over the next decade, it looks like exponential innovation is hunting bigger game, and the world is still long a lot of it. Adapt or Die.

Happy New Year.

**About Weiss:**
More than a market neutral pioneer, Weiss invests in people, partnerships, and a purposeful future. Our mission is to make our expertise in alternatives universally accessible. Jordi Visser is the President and CIO of Weiss. He joined the firm in 2005. Jordi has over 30 years of experience in the investment and finance industry. At Weiss, Jordi oversees the portfolio managers and is responsible for the overall risk aggregation. Additionally, he is the architect and a portfolio manager for the Weiss Alternative Multi-Strategy Fund (Ticker: WEISX), a strategy that reflects the firm's market neutral approach and the desire to make its expertise in alternatives universally accessible. Jordi is the host of the video series, "Real-Time with Jordi Visser" and a lead contributor to the firm's podcast, "In Search of Green Marbles." Prior to joining Weiss, Jordi was the founding Managing Partner of Anchor Point Asset Management, a global macro hedge fund, and a former Managing Director at Morgan Stanley where he held various senior management roles. Jordi has been featured as a guest speaker on various popular podcasts and media outlets. Jordi is a magna cum laude graduate of Manhattan College and a Board Member of the School of Business at Manhattan College.

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