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May 7, 2023

Dear Limited Partner,

In our monthly letters to our investors, we tend to address the short- to intermediate-term prospects for the global and domestic economies, U.S. corporate profits, inflation, interest rates, valuations and the general level of stock prices.

Our most recent commentary last week highlighted some of our mounting concerns relative to the rise in stock prices in the first four months of 2023.

For many reasons, most notably the relationship between the S&P and Nasdaq Indices compared to interest rates (highlighted below), Seabreeze has moved into a small net short exposure in equities:

\* On Friday the Federal Funds Rate stood at 5.08%, the S&P Index closed at 4,136 and the consensus 2023 S&P EPS is projected at \$224/share (which we view as too optimistic!).

\* On 2/24/22 the Federal Funds Rate was at only 0.08% at the time the S&P Index closed at 4,117 and when the forecasted 2023 S&P EPS was projected to be considerably higher (at \$244/share).

In this note and follow up to our May 3rd letter we want to address the longer term and provide a link to a one-hour discussion on this subject by Stan Druckenmiller - who is, in my judgment, the greatest modern day investor and among the most astute macroeconomic thinkers extant.

Here is the link to Stan Druckenmiller's recent talk at The University of Southern California. [https://students.marshall.usc.edu/sites/default/files/USC\\_Marshall\\_CIS-SIF\\_Stan\\_Druckenmiller\\_Keynote\\_2023.mp3](https://students.marshall.usc.edu/sites/default/files/USC_Marshall_CIS-SIF_Stan_Druckenmiller_Keynote_2023.mp3)

My intermediate- to longer- term concerns are multiple and growing (particularly as stock prices climb):

1. A mountain of public debt and a continuing (and out of control) U.S. deficit.
2. The likelihood that inflation will be difficult to arrest.
3. The failure of policy to address supply issues of important commodities (especially oil).

- 4. The absence of cooperation between the world's economic powers.
- 5. The growing probability that interest rates (and the cost of capital) will remain elevated - placing pressure on corporate profitability and stock valuations.
- 6. The end of globalization augurs poorly for corporate profit margins.

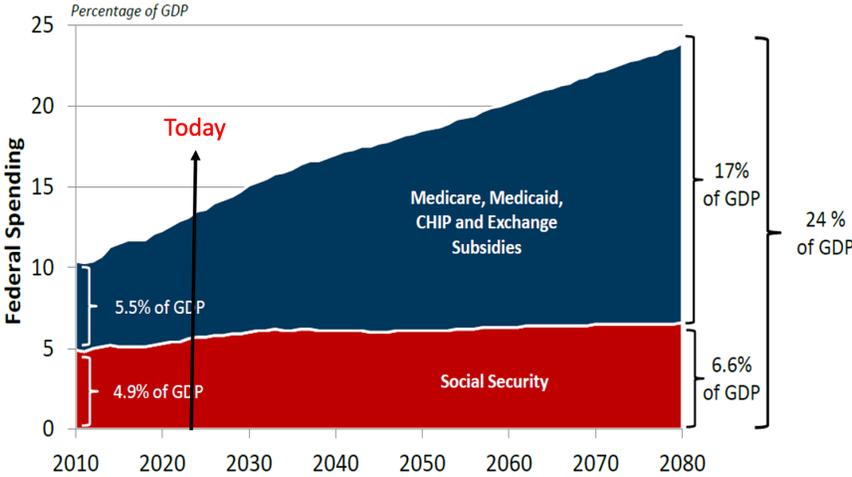
Here are the slides from Stanley’s presentation that outline his principal concerns:

# US exceptionalism at risk?

Stan Druckenmiller

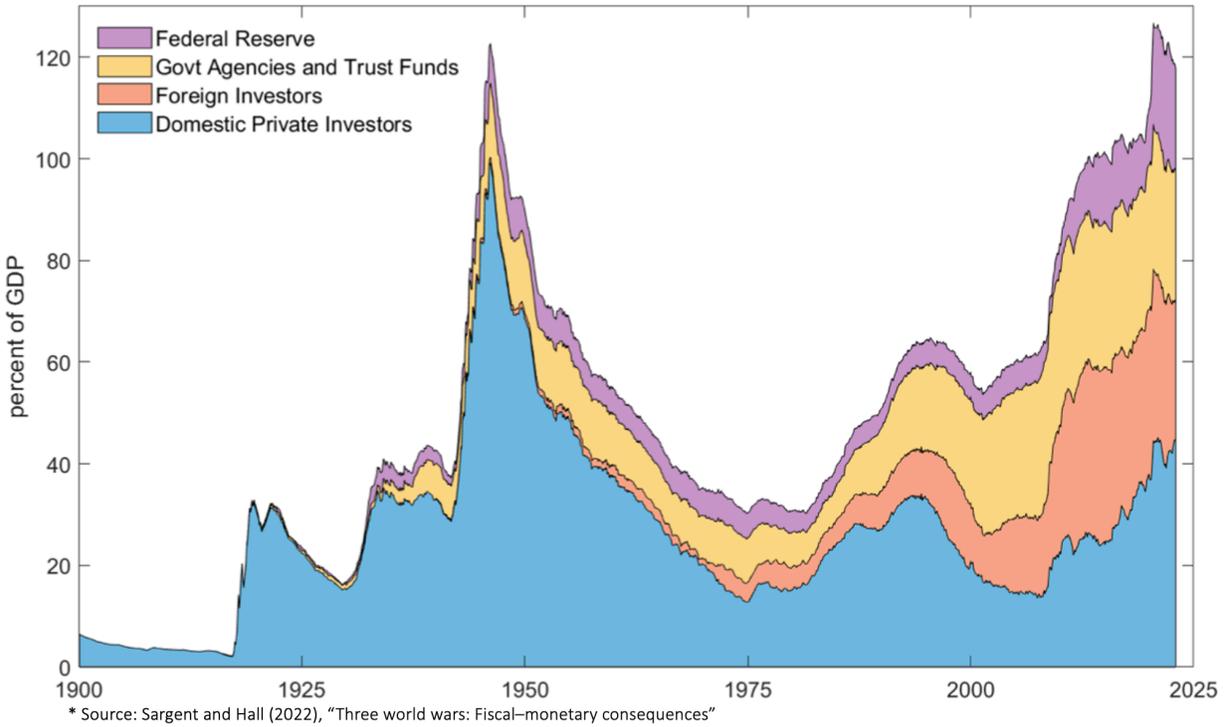
USC Marshall Student Investment Fund  
2023 Annual Meeting  
May 2023

The demographic storm is just getting underway. We are already spending almost 40% of all taxes on seniors. In 20 years, entitlements will cost 60% of all taxes.

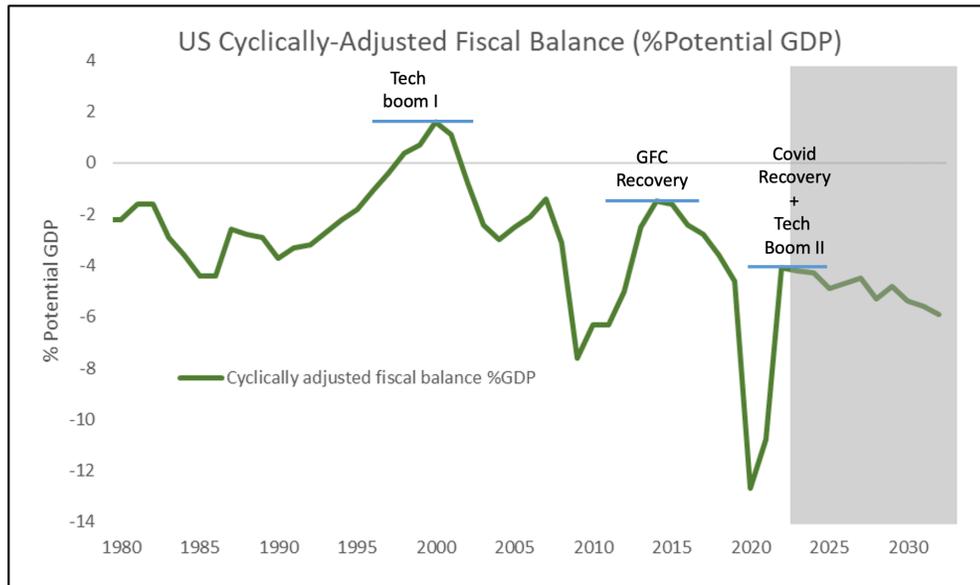


Source: Based on CBO (September, 2013)

The fiscal outlook has gotten worse and is now worse than post World War II



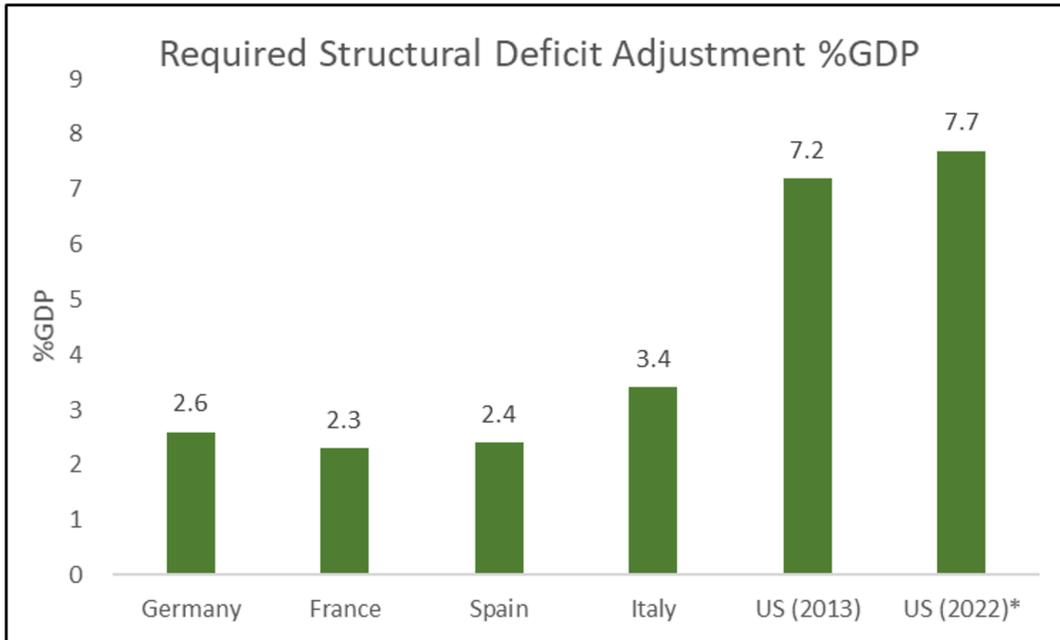
Some missed golden opportunities. Booming economies in 2018 and 2022 never had worse fiscal results. Unless something changes, this Bipartisan "Ratcheting effect" will continue.



\*Source: CBO

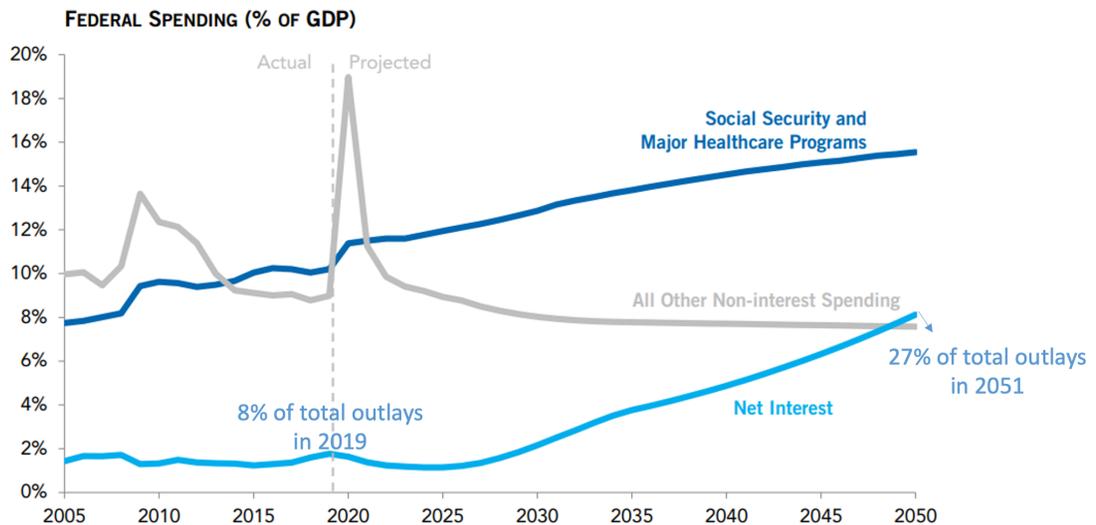
4

The US “fiscal gap” has grown from 7.2% of GDP in 2012 to 7.7% today. This is 3x that in the Euro Area. The more we wait, the worse it becomes.



\*Source: European Commission. For comparison purposes US structural deficit should be 0.8%GDP higher to reduce Debt/GDP to 60% that DE/FR/SP/IT numbers include

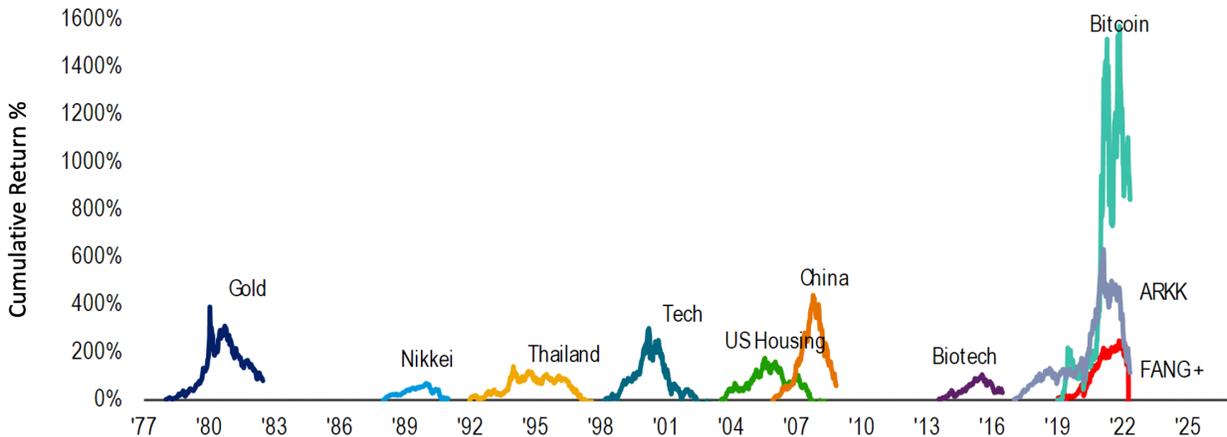
The Fed can't save us. A larger balance sheet temporarily hides and postpones the problem, making it an even worse nightmare once it happens. With 10y rates at 5%, interest payments EVERY YEAR will be as big as the COVID fiscal relief.



SOURCE: Congressional Budget Office, The 2020 Long-Term Budget Outlook, September 2020.

Free money ushered in by Bernanke, Yellen and Powell has enabled reckless fiscal behavior and an asset bubble of historic proportions

### History of asset bubbles



Source: BofA Global Investment Strategy

7

Mark Twain famously said that "history never repeats itself but it does often rhyme." Keep his quote in mind when reading this quote from Stan back in 1987 when he went bearish on equities - as the similarities between today and then are striking:

*"It was a combination of a number of factors. Valuations had gotten extremely overdone: The S&P dividend yield was down to 2.6% (it is now 1.6%) and the price/book value ratio was at an all-time high (it is much higher now). Also, the Fed had been tightening for a period of time (the Fed has been raising interest rates since March, 2022). Finally, my technical analysis showed the breadth wasn't there -- that is, the market's strength was primarily concentrated in the high capitalization stocks, with the broad spectrum of issues lagging well behind. This factor made the rally look like a blow-off."*

As I write this brief note I am watching a live stream of Berkshire Hathaway's 2023 Annual Meeting. (As some of you know, several years ago Warren Buffett invited me to be his "credentialed Bear" and to sit on the dais between him and Charlie Munger and ask tough questions of them throughout the meeting in Omaha).

Not surprisingly, Warren is a long-term optimist on our country and our markets. Years ago he wrote:

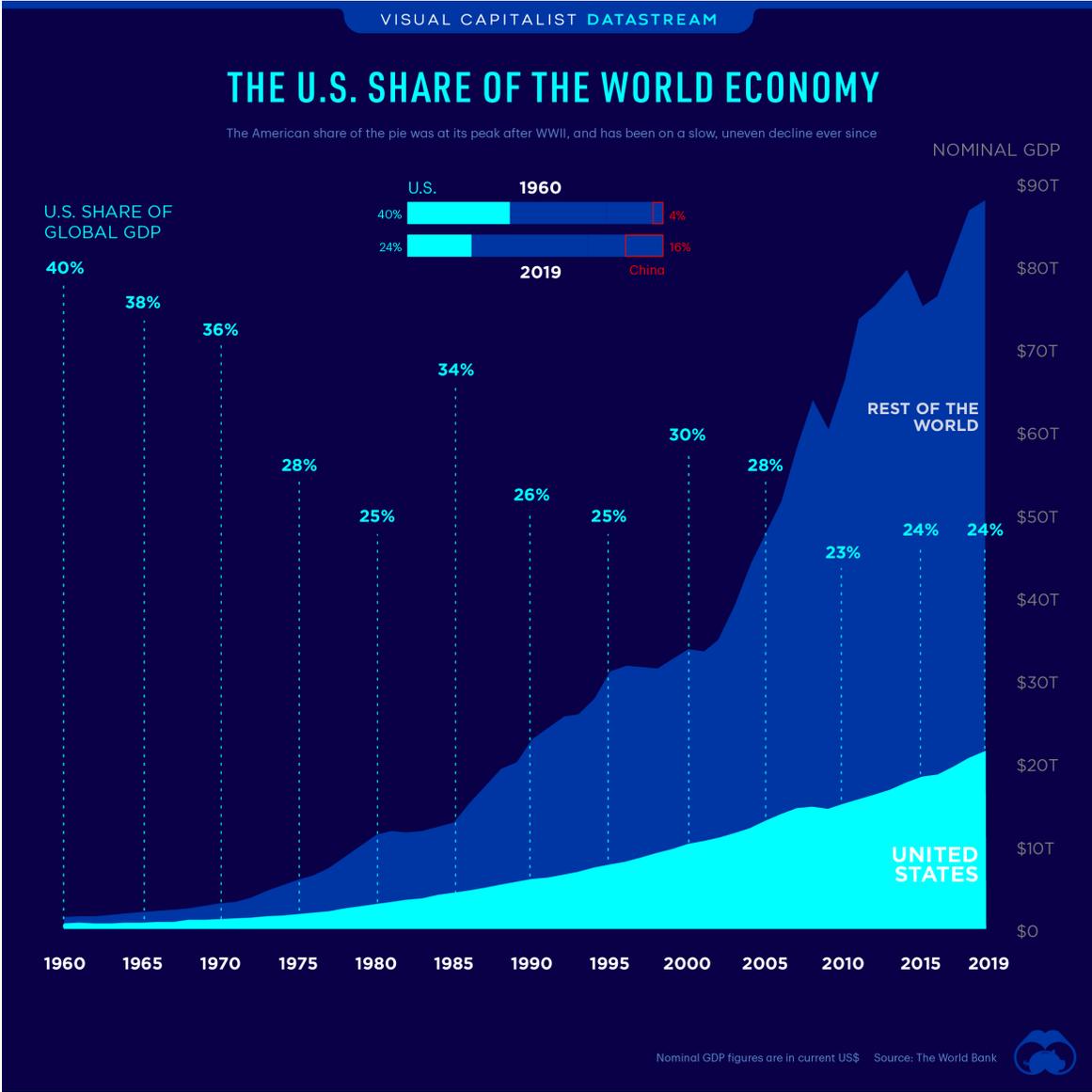
*"In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts: the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced President. Yet the Dow rose from 66 to 11, 497."*

However, in this year's Berkshire meeting even Warren admits that the economic outlook is less certain than in the past.

It was another master class watching hours of Buffett and Munger and a priceless education as always. The notable macro extrapolation was Buffett saying, "The majority of our businesses will report lower earnings this year than last year."

Perhaps this anticipation of an earnings recession coupled with future uncertainties help to explain Berkshire's modest buying of equities in the last few months and why Berkshire Hathaway's cash position currently exceeds \$130 billion.

Speaking of the longer-term, here are some interesting facts which relate to our country's developed/mature economy and our relative worldwide standing (as measured by population and share of global GDP):



In 1776 the Declaration of Independence was unanimously adopted by Congress. In that year the U.S. population approximated only 2.5 million compared to a world population of 800 million. (Two hundred and forty-seven years ago 85% of the U.S. population worked in agriculture!). Our country represented less than one third of one percent of the global population. Today the U.S. population is about 335 million, representing four percent of the world's population of 8 billion people.

Also in 1776, U.S. GDP totaled about only 3.5% of the world's total GDP of \$850 billion. U.S. GDP as a share of world GDP peaked at 40% in 1960. Last year U.S. GDP stood at \$25.5 trillion last year, or slightly less than 25% of the world's total GDP of \$104 trillion.

### **The Joseph Effect**

Recently my former boss, Lee Cooperman (who is also among the best hedge fund managers in history) invoked a Biblical story in a Bloomberg Interview - suggesting, like Stan Druckenmiller, that the outlook for equities over the next several years is subpar. [Watch Leon Cooperman: No Bull Market 'Anytime Soon' - Bloomberg](#)

The Joseph Effect (that Lee mentioned) was coined by mathematician Benoit Mandelbrot and is a term derived from the Old Testament story (in the Book of Genesis) about the Pharaoh's dream as recounted by Joseph. Mathematicians set out to quantify observed cycles into predictable formulas and Mandelbrot quantified The Joseph Effect using the Hurst component. The Hurst component quantifies regression toward the mean over time for any number of price movements.

The vision led the ancient Egyptians to expect a crop famine lasting seven years to follow seven years of a bountiful harvest.

That said, human behavior, as we all know, is affected in great part by recent experience, with a tendency to forget some of the more random and disruptive lessons of the distant past.

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At Seabreeze we are neither Perma Bulls nor Perma Bears -- we are realists.

Our vision of the future is not dystopian. Rather, our vision much like Stan, Lee and Warren - is clouded by the uncertainty of outcomes at a time in which price earnings ratios are inflated relative to history.

Regardless of our market view, when and if stocks fall to attractive levels (and provide a reasonable reward vs. risk and a *margin of safety*), we will be buyers.

We previously invoked Lee's story of Joseph in *The Book of Genesis*.

*The Book of Ecclesiastes* also provides a wonderful metaphor on equities and its cycles:

*To every thing there is a season, and a time to every purpose under the heaven:  
A time to be born, and a time to die; a time to plant, a time to reap that which is planted;  
A time to kill, and a time to heal; a time to break down, and a time to build up;  
A time to weep, and a time to laugh; a time to mourn, and a time to dance;  
A time to cast away stones, and a time to gather stones together;  
A time to embrace, and a time to refrain from embracing;  
A time to gain that which is to get, and a time to lose; a time to keep, and a time to cast  
away;  
A time to rend, and a time to sew; a time to keep silence, and a time to speak;  
A time of love, and a time of hate; a time of war, and a time of peace.*

We have been through among the most speculative periods in history - which came to an abrupt end in late 2021.

At Seabreeze we suspect we may have entered year two of several anticipated lean investment years - much like the 1974-81 period following the end of *The Nifty Fifty*. (This analog was discussed in our April 28 Bloomberg Interview ([Surveillance: Stagflation with Shah - Bloomberg](#) at the twelve minute mark))

A period of *slugflation* (sluggish global economic growth and elevated inflation) forms the foundation of our market concerns.

For now, and perhaps for the several seasons ahead, a traditional buy and hold strategy seems sub optimal.

Fortunately, our investment approach and five-legged strategy (detailed in last week's letter to our Limited Partners) when combined with our comfort, expertise and willingness to short equities suit the more challenging backdrop that Stan Druckenmiller, Lee Cooperman and Seabreeze Capital Partners LP anticipate.

Best Regards,

Douglas A. Kass