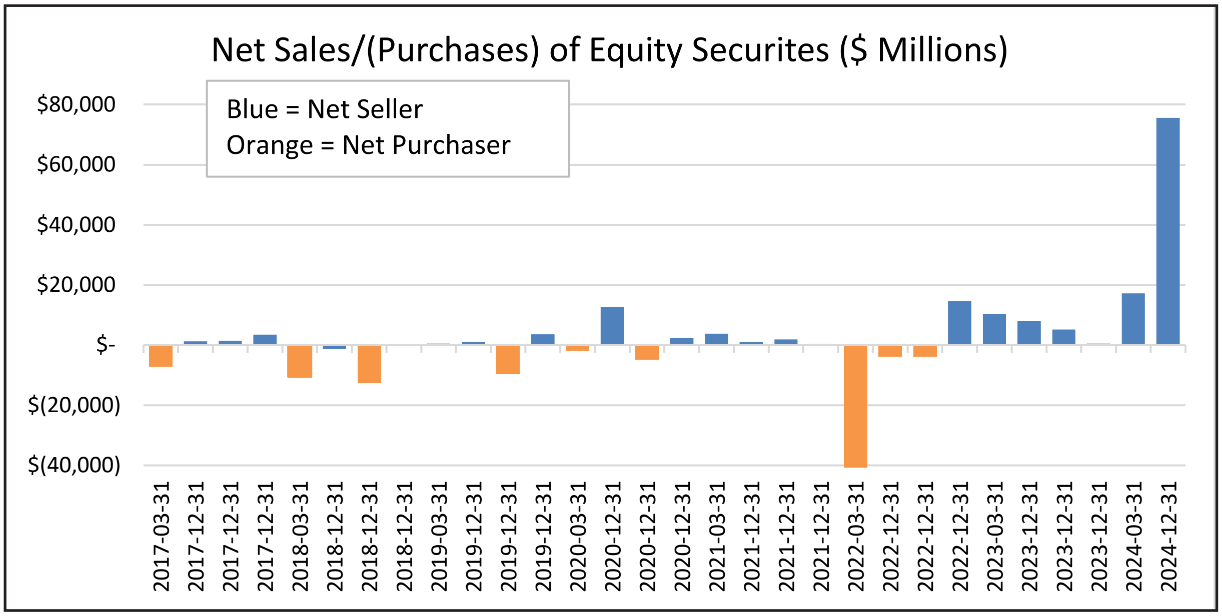
Warren's Cash Buffet(t) - All You Can Sell

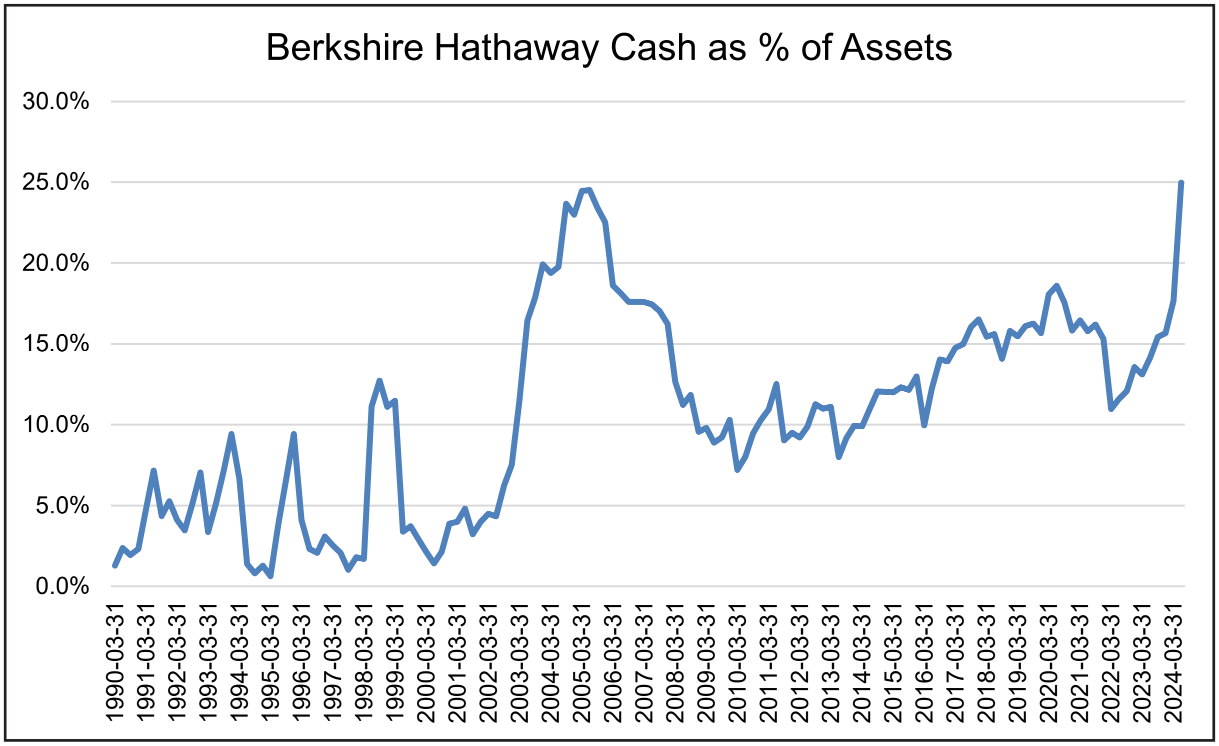
As Warren Buffett presided over Berkshire Hathaway's 2024 annual meeting, he was asked a lot of questions regarding his investing strategy, and the future of Berkshire. One investor question caught our eye and was focused on Berkshire's growing cash pile, Buffett, answered this simply:

"We only swing at pitches we like", Buffett said when asked about why he hasn't used his cash pile to make new investments. "We don't use it now at 5.4% but **we wouldn't use it if it was at 1%**. Don't tell the Federal Reserve," he said jokingly.

This is a clear message, in our opinion, from Buffett that stocks are expensive as he seems uninterested at deploying cash into stocks even if treasuries would provide a very unattractive return of 1%. Buffett must believe the odds are for stocks to provide a likely negative return (worse than the 1% hypothetical return). Notice that he's been selling consistently since 2022. The amount of his selling has never been as big as the recent quarter. If you look at chart 2, you can see Berkshire since 1990, the cash position as a % of assets is now near its 2005 high.



Source: Berkshire Hathaway Financials



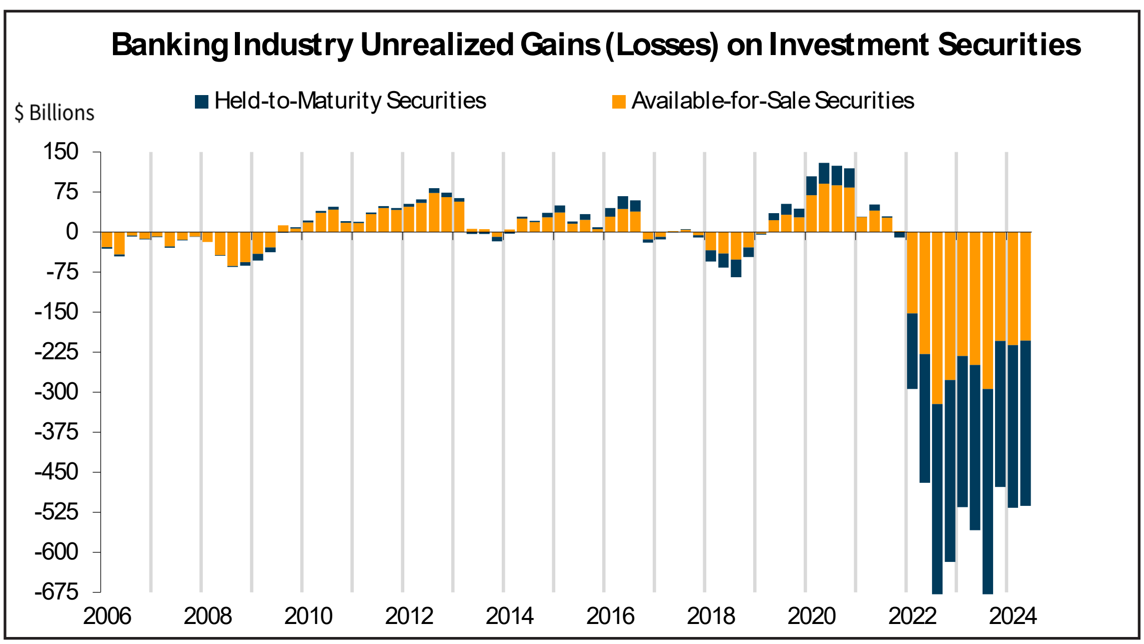
Source: Bloomberg

At the time of writing, Berkshire has sold nearly $8 billion dollars' worth of Bank of America since mid-July.[1] Maybe Mr. Buffett is worried about the unrealized losses and/or the potential future losses if the economy hits a recession? In their Q2 balance sheet, Bank of America were showing unrealized losses of over $110 billion dollars. That equates to nearly half of their tangible equity value.

Source: Bank of America Q2 Financials

Consolidated Balance Sheet		
(Dollars in millions)	**June 30, 2024**	
Assets		
Cash and cash equivalents	320,632	
Federal funds sold and securities borrowed or purchased under agreements to resell	337,752	
Trading account assets	306,466	
Derivative assets	35,956	
Debt securities:		
Carried at fair value	301,051	
Held-to-maturity, at cost (fair value $466,636 and $496,597)	**577,366**	$110.7bln unrealized market-to-market loss
Total debt securities	878,417	
Loans and leases, net of allowance	1,043,547	
Premises and equipment, net	11,917	
Goodwill	**69,021**	$69.2bln in goodwill
Loans held-for-sale (includes $1,572 and $2,059 measured at fair value)	7,043	
Customer and other receivables	80,978	
Other assets (includes $15,314 and $11,861 measured at fair value)	157,898	
Total assets	**$ 3,257,996**	
Total liabilities	**2,964,104**	
Total shareholders' equity	**293,892**	$293.9bln in equity

Many other banks have had a similar problem as Bank of America. You can see the in chart below, which captures the entire industry, that since this problem appeared in early 2022, the situation has barely improved for the industry. This is despite the decline in interest rates (bonds have rallied) and still presents a challenging situations for the banks as that money cannot be deployed at better rates without realizing a loss.



Source: FDIC. Note: Insured Call Report filers only. Unrealized losses on securities solely reflect the difference between the market value and book value of non-equity securities as of quarter end.

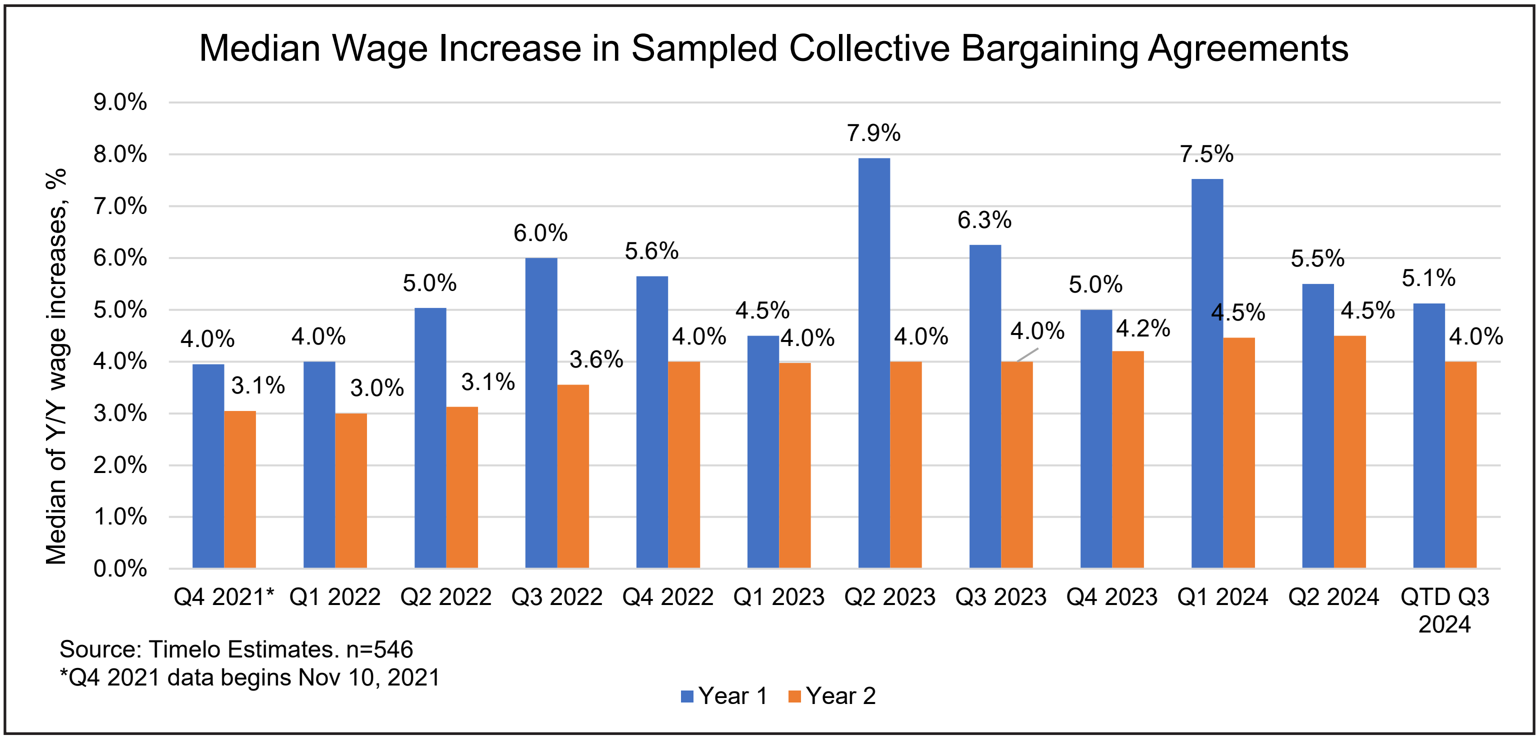
1 https://www.reuters.com/markets/us/buffetts-berkshire-offloads-bank-america-shares-again-total-sales-near-7-bln-2024-09-06/

Bank of America is not alone in the big selling spree from Buffett, Berkshire has also recently halved it's stake in Apple among others.[1] In general, he likely is not seeing the same opportunities in the market where he feels comfortable deploying capital where he once did. If we were going to give credit to Warren Buffett as one of the greatest investors of all time, investors should consider reducing risk exposure as well. In our case, we already have reduced our exposures.

Furthermore, with regards to Berkshire, their insurance czar and vice-chairman, Ajit Jain, has recently halved his stake in Berkshire selling nearly $140 million worth of it.

An Update on Wage Inflation

An important feature of our macro-research is tracking the union negotiations within Canada and the US and gathering data to come up with an estimate for wage inflation. As of late, we have seen a lot of massive gains for union workers in various industries. In California, Disneyland workers got a whopping 45% increase in their wages over 3 years. American Airlines flight attendants got over 31% increases over 5 years, and in recent news, Boeing workers turned down 25% increases over 4 years. Closer to home, Air Canada pilots got 42% increase. Below you can see how sticky the trend of wage inflation is:



As you can see, Year 2 wage increases remain relatively sticky, still at the same levels from nearly 2 years ago. This poses the question: **How are we going to get down to 2% inflation if wages are consistently rising by over 4% YoY?** If productivity was higher, then these wage increases could be justified, however, our productivity has stagnated completely. Furthermore, it seems as if there is a domino effect when other unions in the same industry make large gains in their new contracts, workers for other companies then go to their unions and make demands to at least match these same gains.

1 https://www.reuters.com/business/finance/berkshires-cash-hits-277-bln-buffett-slashes-apple-stake-operating-profit-sets-2024-08-03/

Portfolio Positioning

As discussed above, we share the likely view of Warren Buffett that stocks are generally expensive and are unattractive on a risk-reward basis. This outlook line up with us reducing our risk in the portfolio, like Buffett, while increasing our focus on higher conviction ideas. Most investors seem convinced that lower interest rates will result in a soft landing, but we disagree with that view.

For instance, let's look at the recent US job data. All the net job growth in August was in part-time employment (+ 530k) while full-time jobs plummeted (– 440k), which we consider a definite sign of the job market weakening fast. Furthermore, we believe the current US high deficit is unsustainable and will be reduced through either higher taxes and/or lower spending. Either way would have a significant negative impact on the economy.

Furthermore, manufacturing activity in the U.S. hit its lowest level in 15 months during September, according to a purchase managers index survey on September 23rd from S&P Global. The manufacturing PMI came in at 47.0. That was down from 47.9 in August for the lowest reading since June 2023, and below the Dow Jones estimate for 48.4.[1]

On the other side of the world, Germany's economy is getting worse and probably is now in a bad recession. Its most recent manufacturing PMI reading of 40.3 that was below expectations (42.4) and below last month's reading (42.4). Also, China is no longer a locomotive for the world economy (quite the contrary).

It will be very difficult for the Fed to bring inflation down to 2% with the current wage inflation running well above that (roughly 5%) unless we hit a recession. Unfortunately for the bullish investors, the markets decline significantly on average during those recessions.

Here's what Perplexity AI says:

"The S&P 500 typically experiences significant declines during recession, though the exact magnitude can vary:

- Since 1950, the S&P 500 has declined by 20% or more on 13 different occasions.
- The average stock market price decline during these major downturns is approximately 32.73%"

So don't always believe what the guy on TV says…

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