Kinetics Mutual Funds
Third Quarter 2023 Commentaries

The Paradigm Fund

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Financial markets and risk asset prices continue to be supported by a resilient global economy, which is growing despite sustained monetary tightening across most of the world. In fact, the Atlanta Federal Reserve estimates that the U.S. economy grew at an annualized rate of 4.9% in the third quarter, even as the Federal Reserve raised interest rates by an incremental 100 basis points so far this year.

According to monetarist economics—a school of thought emphasizing the governmental role in controlling the amount of currency in circulation—the broad level of money supply has significant influence over short-run economic growth (GDP) and intermediate term price levels (inflation). However, despite a year-over-year total money supply (M2) decrease of 3.5% in September, economic growth persists. Furthermore, according to the Intercontinental Exchange (ICE) U.S. Dollar Inflation Expectations Indexes, the market expects inflation will dip to 2.22% in 2024.

We believe the economy is defying conventional (monetarist) wisdom for several reasons. Primarily, while M2 annual growth is currently negative—which has not happened in the prior 60 years of data—this must be evaluated against cumulative M2 growth in excess of 40% over the 18 months following the start of the pandemic. Accordingly, M2 remains approximately 36% above pre-pandemic levels, which corresponds to over 9% annualized money supply growth. This translates to an additional $5 trillion of capital in the U.S. monetary system than there was before 2020.

Secondarily, the impact of higher interest rates on businesses, consumers, and the broader economy occurs on a lag. U.S. corporate debt has an average maturity of 10.94 years, and U.S. mortgage debt has an average maturity of 7.76 years. Eventually, these debts will need to be refinanced, and presumably, at higher interest rates. Corporate and mortgage debt are the two largest categories of non-government debt outstanding, at approximately $13 trillion and $20 trillion, respectively, as of the second quarter of this year. Of course, there are also floating-rate debts—notably, credit cards and certain types of auto loans, but these are very small compared to the corporate and mortgage debt.

One other aspect of higher rates is that they impact supply, just as they impact demand. The first order analysis of higher interest rates focuses on consumers (demand) and the deleterious impact of higher debt service costs that result from higher interest rates. However, the second order effect involves businesses that, recognizing the consumer impact, adjust spending plans (supply). It should not be forgotten that the businesses are equally—if not more—sensitive to debt service and funding costs than consumers.

Counterintuitively, this dynamic has supported price levels, and may boost prices further, as low inventories will soon require restocking. The value of U.S. business inventories surged over 30% between the summer of 2020 and the fall of 2022 but has been largely unchanged over the past year. This data supports a large inventory destocking cycle, particularly as price levels have risen by over 20% during this period, thus inflating the notional level of inventories. In real terms, inventories have dropped approximately 2.5%, something that hasn't occurred in the past 30 years, outside of a recession. This will challenge the market's expectations of inflation moderating next year—business input costs are rising by virtue of under-investment and raw materials shortages, and companies will attempt to pass costs along to consumers. Inventory destocking, particularly inventories with inflated values, can boost short-term profit margins until, of course, the inventories must be restocked.

In our opinion, the largest factor diluting the expected dampening impact of monetary policy has been fiscal policy. The U.S. Federal government has run recent budget deficits of $3.13 trillion (2020), $2.77 trillion (2021), and $1.38 trillion (2022). Annual deficits are forecasted, perhaps optimistically, by the Office of Management and Budget (OMB) to be in the $800 billion to $1 trillion range through 2030, which will drive U.S. federal debt (net) interest payments to exceed $1 trillion by 2028. This capital has been injected into the real economy directly, in the form of fiscal spending, and indirectly, via rising interest payments to holders of U.S. debt. We believe this has been a major driver of the resilience of the U.S. and global economies, and Congress shows few signs of slowing spending.

With fiscal policy functioning in direct opposition to monetary policy, the biggest result thus far has been higher interest rates than anyone had imagined feasible this business cycle, sending long-term bond prices much lower while supporting the U.S. Dollar. All else being equal, this would not be considered an accommodative environment for richly valued technology stocks. Yet, the Nasdaq Composite rose over 34% in the first nine months of 2023. The large technology companies in the Nasdaq have also been primarily responsible for the S&P 500 Index rising over 13% for the year. A portion of the strength in equities can be explained by the ambitious earnings growth expectations of nearly 10% for the S&P 500 Index this year, followed by another 12% in 2024.

Even if these lofty numbers are achieved, the market trades at approximately 18x 2024 earnings, an earnings yield (5.5%) that is nearly equivalent to the current Federal Funds Rate. The last time that the forward earnings yield on the S&P 500 was this low—that is, expensive, with no allowance for valuation risk—relative to the Federal Funds rate in early 2001, in the aftermath of the Nasdaq technology bubble, when the rate was approximately 5%. It should be noted that, near the peak of the technology bubble in early 2000, the Federal Funds rate reached 6.5%, compared to a forward earnings yield of 4.1% for the S&P 500, resulting in the nadir of a negative 2.4% comparative yield between Fed Funds and earnings.

The economic backdrop in 2000-2001 set the stage for one of the best relative periods for value investing and natural resources in modern history. There are obvious nuances to this environment, but the parallels to current markets are undeniable. We would not be surprised to see a similar return profile going forward, though we can hope the global financial crisis—which began to develop from market dynamics in the early 2000s—doesn't repeat itself with a sovereign-style credit/currency crisis this time around.

The range of potential economic scenarios from this point is growing, particularly at the tails of the probability distribution. We believe the most likely scenario is higher structural inflation, which will keep Federal Reserve policy "restrictive"—hence, considerably higher interest rates as compared to the previous business cycle. The ultimate problem with this outcome is that the real federal debt burden will continue to expand unless nominal economic growth exceeds the cost of debt.

To be sure, the past three years of high nominal economic growth (boosted by inflation) and low interest rates have been paramount in reducing the real debt burden. U.S. Federal debt to GDP peaked at approximately 132% in the second quarter of 2020, but it has fallen to approximately 120% today, despite cumulative federal fiscal deficits of approximately $7.4 trillion. Thus, the only reason for the "improvement" in the budget has been cumulative nominal economic growth (inflation assisted) of 36%. If economic forecasts prove prescient, forward economic growth is only marginally higher than the current weighted average cost of federal debt. Ergo, all else being equal, the planned future deficits will grow relative to GDP.

Nominal growth—in other words, including the inflation/price component of GDP—is the only method for the country's finances to improve, absent austerity or default. Thus, it may be a question of when, not if, the 2% inflation target will be revised higher, either implicitly or explicitly, and quantitative easing or "yield curve control" will be reintroduced. In such an environment, money and other financial assets, such as bonds, lose purchasing power, and real assets will be the premier asset class on a secular basis.

The path to this outcome is ever uncertain; hence, our emphasis on capital-light hard asset companies. To summarize this thesis, the most successful companies will be those which own scarce real assets, and which operate efficient business models not meaningfully impacted by rising operating or capital costs—which, in turn, allow the (rising) value of these scarce assets to accrue to the equity holders. There is a limited universe of such businesses; in fact, there is not nearly enough capacity for the institutional complex to build meaningful exposure, although this might not prevent them from trying.

Paradigm Fund
Top 10 Holdings (%) as of September 30, 2023

Texas Pacific Land Corp	63.7%
Grayscale Bitcoin Trust	4.3%
Brookfield Corp.	2.9%
Franco-Nevada Corp	2.6%
Live Nation Entertainment, Inc.	2.6%
Howard Hughes Holdings, Inc.	2.5%
CACI International, Inc. - Class A	1.7%
CBOE Global Markets Inc.	1.1%
Associated Capital Group, Inc. - Class A	1.1%
Liberty Broadband Corporation - Series C	1.0%

Important Risk Disclosures

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In addition, investing in foreign securities involves more risk than just U.S. investments, including the risk of currency fluctuations, political and economic instability, and differences in financial reporting standards. There may also be heightened risks investing in non-investment grade debt securities and the use of options. There are also risks associated with investing in small and medium sized companies. Non-investment grade debt securities, i.e., junk bonds, are subject to greater credit risk, price volatility and risk of loss than investment grade securities. Options contain special risks including the imperfect correlation between the value of the option and the value of the underlying asset.

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Please refer to the Fund's prospectus for a complete list of risks and fees.

The Paradigm Fund is classified as a non-diversified fund. Therefore, the value of its shares may fluctuate more than shares invested in a broader range of industries. In a non-diversified fund, more of the Fund's assets may be concentrated in the common stock of any single issuer, which may make the value of the Fund's shares more susceptible to certain risks than shares of a diversified mutual fund.

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The S&P 500® Index represents an unmanaged, broad-based basket of stocks. It is typically used as a proxy for overall market performance. S&P Style Indices divide the complete market capitalization of each parent index into growth and value segments. The Nasdaq-100® is one of the world's preeminent large-cap growth indexes. It includes 100 of the largest domestic and international non-financial companies listed on the Nasdaq Stock Market based on market capitalization. The Russell 3000 Growth Index is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States. The Russell 3000 Growth Index is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

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