Whac-A-Mole

A stealthy world war is developing. Unlike previous world wars, the belligerents do not seek continental conquest. They only want to take nearby lands.

Until now, the post-WWII order has kept countries from invading neighbors. America's defense and trade alliances, which provide military protection and economic opportunity to members, maintained a peaceful order. On the rare occasion when a nation invaded a member, the alliance gathered its forces to brutally punish the perpetrator. Iraq 1991 serves as the example.

The belligerents of our day learned from Sadaam Hussein's failure. They now act in concert with others to create chaos around the world. If multiple battlefields pop up simultaneously, the U.S.-sponsored alliance can no longer concentrate all its firepower on a single foe.

A confederation of aggressors (Russia, China, and Iran) is forcing the U.S. to play "Whac-A-Mole" across a global battlefield. They seek to dilute and drain the military resources of the alliance. If successful, they will force the U.S to prioritize military resources and retreat from certain battlefields… ceding control of conquered territories to belligerents.

The Russia Front

Russia kicked off the "Whac-A-Mole" war with its invasion of Ukraine. America and NATO responded by providing Ukraine with abundant weapons, supplies, and training… resulting in a stalemate. The opposing armies are rapidly consuming conventional armaments… just to hold ground. Consequently, U.S. stockpiles of 155mm artillery shells and stinger missiles are already running low.

The China Front

As detailed in Issue 11 of *Vigilante Investor Quarterly,* China is preparing to invade Taiwan next year. The U.S. can supply Taiwan with sufficient weaponry to hit China hard. However, The U.S. cannot prevent a Chinese takeover of Taiwan.

In the aftermath the Taiwan invasion, America will engage China in a punishing economic war. America's goal will be to topple China's communist government and restore Taiwan's independence. The war will feature sanctions, trade embargoes, and naval blockades of vital supplies (oil, gas, coal, and other natural resources.) If America can isolate and starve China's economy for more than two years, it may succeed at inciting revolution.

However, the collateral damage of economic war could defeat America's plan. Supply chains in most industries depend on imports from China and Taiwan.

- China "accounts for 63% of the world's rare earth mining, 85 percent of rare earth processing, and 92 percent of rare earth magnet production.[1]
- Consumers depend on China to manufacture electronics. Despite attempts to diversify supply chains, Apple still sources about 95% of iPhones from China (as of 2022.)[2]
- China produces between 70% and 90% of U.S. antibiotics supplies.

[1] China Dominates the Rare Earths Market. This U.S. Mine Is Trying to Change That. - POLITICO
[2] Apple's dependence on China cut to 36%, but iPhone problematic (9to5mac.com)

- Taiwan produces about 25% of the world's semiconductors.

The loss of Taiwan's chip production would cripple cloud computing, AI, automobile manufacturing, and multiple other industries. It could take four years to rebuild new foundries that replace Taiwanese production. This might drag down the economy for years.

China has prepared for the coming economic war… by stockpiling critical supplies. If China can stockpile enough supplies to outlast the patience of the American people, it can negotiate a peaceful settlement. Communist China would own Taiwan, uncontested.

The Iran Front

The October 7 Hamas raids established a third front in the new global war.

Israel is now responding with an invasion of Gaza. The situation could escalate into a serious conflict. For example, Iran-sponsored Hezbollah wants to raid northern Israel in retaliation for Israel's invasion of Gaza. In return, Israel might raid Hezbollah in Lebanon. Then Turkey may intervene on behalf of Lebanon. The situation could easily spin out of control.

To tamp down escalation risks, the U.S. has deployed two carrier task forces to the region. Thus, the U.S has devoted 20% of its naval firepower to whack the Iranian mole.

Meanwhile, Iran has gone to war with the U.S.

- Iran and its proxy forces have launched over eighty attacks on U.S. troops in Syria in the past 3 years. The attacks in Syria are now escalating.
- The USS Carney, a guided-missile destroyer, intercepted fifteen drones and four cruise missiles fired by Iran-backed Houthi troops in recent weeks.
- Iran launched multiple drone attacks on U.S. troops in Iraq this past week.

So far, the U.S. has downplayed hostilities with Iran. It swatted at the Iranian attacks like flies. In a measured response, the U.S. launched precision airstrikes against two Iranian bases in Syria.

Iran will continue to attack U.S. forces in the region. Iran wants to escalate hostilities in hope of harming the U.S. badly. It wants America to abandon the region… like Beirut in 1983.

Keep in mind, American troops stationed in Kuwait now deter an Iranian invasion of Saudi oilfields. If ever America leaves Kuwait, the massive Iranian army will march across the Kuwaiti dessert and into Saudi Arabia.

The Home Front

The fourth and final front will emerge across so-called Western democracies. Terrorism and sabotage will bring the war to the citizens of Europe and the U.S.

Middle eastern migrants have been pouring into western Europe for years.

Since President Biden opened the southern border, migrants have poured into the U.S. too. Most migrants are military-aged males. Customs and Border Patrol (CBP) encountered 4,366 migrants from China, and it estimates that the actual number of Chinese migrants is more than double those encountered. CBP also encountered 71,684 migrants from middle eastern countries, including 763 known or suspected terrorists. Unquestionably, even more terrorists have slipped through the border, undetected.

Most migrants have peaceful intentions. However, the terrorist migrants intend to do grievous harm. They represent a ticking bomb, timed to detonate when America is most vulnerable. It will open a fourth front in the war… aimed at forcing America to prioritize defense of the homeland and abandon foreign battlefields.

Ditto for Europe.

General Economic Impacts of War

Defense spending could give the economy a modest boost. However, supply disruptions will force some sectors of the economy to contract. The overall impact on growth is hard to predict.

Supply disruptions can drive prices in both directions. The market will ration shortages of imports by raising prices. In parallel, the market will clear out excess inventories (created by the closure of export markets) by cutting prices.

Election Year Considerations

Since 1920, every "election-year recession" has led to a change of control of the White House.

Table 1: Political Change and Election Year Recessions

Election Year	Recession	%Change in GDP	Result
1920	Jan 1920-July 1921	-38.1%	Harding - landslide
1932	Aug 1929-Mar 1933	-26.7%	Roosevelt - landslide
1960	April 1960- Feb 1961	-1.6%	Kennedy- narrow
1980	Jan 1980-July 1980	-2.2%	Reagan- decisive
1992	July 1990-Mar 1991	-1.4%	Clinton-decisive
2008	Dec 2007-June 2009	-5.1%	Obama - decisive
2020	Feb 2020-April 2020	-19.2%	Biden- narrow

In 1992, James Carville succinctly stated what matters most in Presidential elections… "It's the economy, stupid!"

The Fed will quickly respond to a weaker economy by cutting rates. The Fed does not like inflation. However, its # 1 priority is to protect the institution (of the Federal Reserve) and maintain control of monetary policy. Thus, the Fed will do whatever is necessary to avoid blame for electoral results. The Fed's only real tool is the interest rate. So, even if inflation remains elevated, the Fed will lower rates next year.

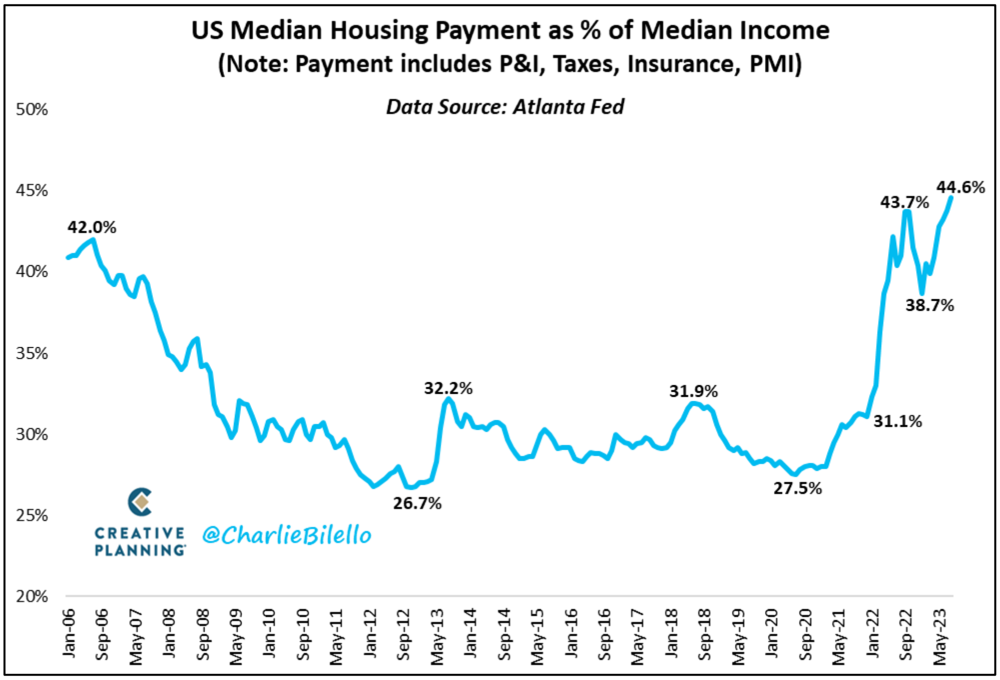
Meanwhile, supplemental defense spending will force the Treasury to issue more long-term bonds. This may keep long-term rates at elevated levels, even as the Fed lowers the short-term rate.

A Tough Housing Market

Housing was a great investment in 2020. It will be a terrible investment in 2024.

Home prices soared in 2021. Then, long-term interest rates soared in 2022 and 2023, causing home financing costs to do the same. Figure 1 shows how the compounding of factors made housing unaffordable. The cost of a home, as a percentage of buyer income, is now higher than at any time in the last 40 years.

Figure 1: Home Purchase Affordability



The last time housing costs rose above 40% of income was 2006. It led to a housing market collapse from 2008-2010.

Nevertheless, home prices will not fall as hard in 2024 as they did in 2008. Back then, banks foreclosed and liquidated almost 4 million homes, which put enormous downward pressure on home prices.

Two factors limit the risk of a housing collapse. 1) Solid loan underwriting standards on the pool of existing mortgages reduces the risk of fraudulent loans. 2) Most current homeowners enjoy the benefit of low fixed-rate mortgages. This improves the financial security of homeowners and limits the inventory of homes for sale. No one wants to give up a 2.8% mortgage! So, even if a recession leads to job losses, the housing market should remain stable.

However, housing remains unaffordable for anyone who wants to buy a home. Until long-term interest rates decline, anyone who needs to sell a home will need to cut the price.

The Economy

Despite 4.9% growth in the third quarter of 2023, the U.S. economy is sliding into recession. The growth indicator favors growth by a score of 2-to-1, its smallest margin since 2020.

Due to price increases in gold and oil, the inflation indicator rose to a 4-to-0 score. This demonstrates intensifying inflation pressures.

Table 2: Vigilante Investor Scorecard of Economic Conditions Oct 27, 2023

Score	Positive	Neutral	Negative
Growth 2 Contraction 1	US Real GDP +2.9%YOY US Non-Manf PMI 53.6	Fed Signal +1.0% US Productivity +1.4% Global Comp PMI 50.5	US 2-10 Spread -0.17%
Inflation 4 Deflation 0	CPI +3.7% YOY US Wages +4.2% YOY Gold +13.0% YOY Gold / Euro +15.0%YOY	US Dollar +0.2% YOY Crude Oil -4.2% YOY	
Positive $ 2 Negative $ 0	US-Ger2YR Spread +1.95% US-Ger10YR Spread+2.04%		

Sources: Tradingeconomics.com, St. Louis Fed, and Investing.com

Stock Market Valuation

Figure 2: S&P 500 Long-Term Log Chart as of Oct 27, 2023

Figure 2 shows the S&P 500 remains in the middle of the long-term historical valuation range.

Because of high inflation, high long-term interest rates, and risks from war, the stock market needs a higher risk premium. Therefore, the S&P 500 Index will move to the lower end of the historical valuation range… between 2950 and 3450.

Investment Strategy

To summarize the investment environment-

- War is spreading around the globe. It will usher in a period of supply-chain disruptions, dislocations, and price instability. It will also elevate defense spending, fuel inflation, and keep long-term interest rates at elevated levels.
- The U.S. economy will contract in 2024, and the Fed will lower short-term interest rates.
- High long-term interest rates will continue to depress asset prices.

Under these ominous conditions, *Vigilante Investor* recommends a cautious near-term posture… but an opportunistic plan going forward.

1. Incrementally cut stock market positions while retaining significant exposure to the energy and insurance sectors.
2. Lock in high short-term interest rates before the Fed starts cutting. Begin accumulating high-quality short-term bonds.
3. Prepare for the opportunity to buy cheap assets. Develop a bargain-hunting list of target stocks. Know the price you want to pay.

#1- Sell positions in Plains All American Pipeline LP **(PAA)** and Black Stone Minerals LP **(BSM)**. Add a position in KLX Energy Service Inc **(KLXE).**

Both PAA and BSM represent conservative bets on the U.S. oil & gas industry. With production rising, we can optimize our portfolio with a more aggressive position.

Domestic oil production needs to increase. Foreign oil supplies will be less dependable during wartime. The Biden Administration's oil price manipulation left the Strategic Petroleum Reserve depleted. The margin of error on oil supplies is dangerously low. America desperately needs more domestic oil production.

The need for natural gas production is even more compelling. LNG export facilities will double their capacity over the next 5 years. The combined effect of rising exports and rising domestic demand will require 20% more gas production in the coming years.

KLX Energy Services Holdings, Inc (KLXE)

When production rises, service companies tend to outperform. Also, the lack of recent capital investment in oilfield services will amplify the sector's return potential going forward.

KLX Energy provides drilling, completion, and production services in the southwestern, Appalachian, and Rocky Mountain shale basins of the United States. Services include directional drilling, downhole navigation, coil tubing, pressure pumping, cementing, wireline, rental tools, flowback, and snubbing.

KLX's services the top exploration and production companies in the U.S, including Chevron, XTO (Exxon), Conoco Phillips, Southwestern Energy, Diamondback, and Devon.

Table 3: KLX Energy Services as of 10/27/2023

Ticker	KLXE	**EPS**	$3.38	**Forward P/E**	3.43
Price	$10.21	**EPS Forecast**	$2.98	**Expected 5-Yr Growth**	10.8%
Book/Share	$2.42	**Market Cap**	$168M	**Debt/Equity Ratio**	8.85x
Dividend Yield	NA	**Enterprise Value**	$437M	**Net Debt/Ent Value**	0.46

Sources: Finviz.com, Yahoo Finance, Shareholder Report

Despite operating a highly cyclical business, KLX has performed consistently well. Except for the pandemic-related oil & gas depression, KLX has consistently produced positive EBITDA.

The company is growing revenues and earnings while steadily decreasing net debt. The company plans to continue to de-lever its balance sheet going forward. As net debt diminishes, stock valuations should improve.

KLX recently acquired Greene's Energy Group in an all-stock transaction. The acquisition adds scale, lowers average costs, and improves operating margins.

Recommended Strategy: Buy half a position of KLXE at current prices. Add another half position below $9.50 per share.

Figure 3: KLX Energy Services as of 10/27/2023

#2- Lock in (currently) high short-term interest rates before the Fed begins to cut rates.

Vigilante Investor seeks to use about half of the current cash balance to buy short-term bonds. Our vehicle of choice is the Vanguard Short Term Corporate Bond ETF. Table 4 summarizes fund composition, yield, and cost.

Table 4: Vanguard Short-Term Corporate Fund ETF

Fund Name	Vanguard Short-Term Corporate ETF
Symbol	VCSH
Portfolio Composition	Investment Grade
% Rated AAA&AA	8.60%
% Rated A	46.90%
% Rated BBB	44.60%
Average Maturity	2.9 Years
Yield to Maturity	6.00%
Expense Ratio	0.04%
SEC 30-Day Yield	5.94%

Source: Vanguard.com

#3- Prepare for the opportunity to buy cheap assets. Develop a list of target stocks to buy.

Vigilante Investor shares a preliminary list of target stock purchases in Table 5. This list will change along with conditions, company performance, and expectations.

Table 5: Target Stocks

Company	Symbol	Avg Target Price	Fwd PE at Target
Lockheed Martin Corp	LMT	$340	12.3
Intel Corp	INTC	$24	12.7
Texas Instruments Inc.	TXN	$120	18.5
NXP Semiconductors NV	NXPI	$100	8.3
MasTec	MTZ	$35	6.8
Cleveland-Cliffs Inc	CLF	$8	4.3
Nine Energy	NINE	$2	NA

Portfolio Review

Despite a 10% correction in the S&P 500 index, the Vigilante portfolio held steady. It is anchored by 40% cash-like investments and buoyed by energy and insurance holdings.

Table 6: The Vigilante Model Portfolio as of 10/27/2023

All ETF Portfolio	%	Selections	Symbol	Initial Price	Price Apr 28
Broad Market	4%	VG Mid-Cap Value ETF	VOE	$122.88	$124.25
	4%	VG Large-Cap Value ETF	VTV	$121.81	$131.82
Financials	4%	VG Financials	VFH	$88.21	$75.97
	14%	iShares U.S. Insurance	IAK	$84.25	$91.36
Energy	24%	First Trust Revere Nat Gas	FCG	$19.01	$25.91
Real Estate	0%				
Precious Matals	5%	VanEck Vectors Gold Miners	GDX	$32.75	$29.20
	5%	Global X Silver Miners	SIL	$39.51	$24.67
TIPS	*20%*	VG ST Infl Protected Sec ETF	VIPSX	$12.90	$11.40
Short Term Bonds	*10%*	VG ST Corporate Bond ETF	VCSH	$74.95	$74.95
Cash	10%	Broker MoneyFund			

Table 6: The Vigilante Model Portfolio as of 10/27/2023

Sector	%	Selections	Symbol	Initial Price	Price July 27
Defense	4%	Rtx Corporation	RTX	$85.17	$79.15
Financials	16%	Chubb	CB	$165.98	$208.55
		AIG	AIG	$47.54	$59.53
		WR Berkley	WRB	$53.58	$65.32
		Bank OZK	OZK	$34.86	$35.16
Energy	26%	ProPetro	PUMP	$8.25	$10.51
		Diamondback Energy	FANG	$61.33	$160.05
		Black Stone Minerals	BSM	$17.36	$17.80
		Coterra (Formerly Cabot)	CTRA	$18.69	$27.70
		Southwestern Energy	SWN	$4.06	$7.07
		Antero Resources Corporation	AR	$32.67	$28.89
		Plains All American Pipeln	PAA	$9.02	$15.15
		Cameco Corp	CCJ	$12.73	$37.94
		KLX Energy Services	KLXE	$10.21	$10.21
Agriculture	4%	Mosaic Co	MOS	$28.67	$33.03
Precious Metals	10%	Junior Gold Miners ETF	GDXJ	$46.02	$34.43
		Gold Miners Index	GDX	$29.30	$29.20
		Pan American Silver	PAAS	$21.13	$15.11
		Silver Miners ETF	SIL	$42.00	$24.67
		Newmont Mining	NEM	$53.32	$38.97
TIPS	18%	VG ST Infl Protected Sec ETF	VIPSX	$12.90	$11.40
Short Terrm Bonds	11%	VG ST Corporate Bond ETF	VCSH	$74.95	$74.95
Cash	11%	Broker Money Fund			

Keep in mind, we sold half of our investment in Bank OZK last quarter, and we intend to buy the shares back if Bank OZK trades below the tangible book value of $33 per share.

We live in interesting times.

All the Best

Steve Koomar

October 30, 2023

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