Quarterly Brief

Exclusive updates and insights for discerning investors.

Q2 2024

General Commentary

Our view of the world has not changed. We expect increased economic and financial market risks over the short and medium term. We do not believe the world is ending, but we think a greater emphasis on capital preservation versus growth is prudent.

Our concerns include the impact of higher interest rates not being fully felt across the broader economy, entering a volatile and contentious election season, the Middle East teeming with ongoing conflicts that could escalate at any moment, and the AI tech bubble starting to deflate. To be clear, we are not advocating market timing or the sale of all our holdings, but we are maintaining a more defensive posture.

Our mandate remains clear – we are focused on long-term success through capital preservation and a long-term investment mindset. We have materially slowed new real estate and private equity investments to reflect this thinking. However, in the long term, there is plenty to be optimistic about. The foreseeable uses of AI technology will have a profoundly positive impact on healthcare, science, manufacturing, travel, and finance. We are excited to be investors during this period of change in society.

Should we experience increased volatility or a significant decline in prices, we expect to deploy our cash prudently and be patient in looking for only those opportunities that fit our investment criteria.

Financial Markets

The mini AI bubble has started to deflate as we've seen most AI-related investments decline in value. Business models, cash flows, and prospects are all undergoing a higher level of scrutiny and it's unclear how AI providers will earn a reasonable return on the capital being spent. Despite the growing questions around profits and the viability of business models, we believe that AI has a meaningful role in our everyday lives. We have some AI-related investment exposure today but will look for opportunities if valuations continue declining.

With each passing week, we observe a weaker U.S. economy. The economic data shows a deteriorating employment picture, increasing consumer credit card and auto loan delinquencies, and reduced consumer spending. All these data points indicate a slowing economy and will ultimately result in the Federal Reserve lowering interest rates. Where the markets go from here is less clear. Either way, we are prepared to continue to fulfill our long-term mandate of owning high-quality investments operated by high-quality leaders at a reasonable price.

This economic slowing reflects our short to medium-term concerns. The longer-term worry that is less talked about but potentially the most problematic for the financial markets, is the increasing level of government deficits and the associated level of government debt.

Today, there is little concern for the spiraling amount of debt, but eventually, we will need to address this growing problem. The U.S. is now spending $1 Trillion on interest expense alone. The current interest paid on this debt is 3.33%, below prevailing rates and below the long-term cost of government debt. We expect that in the coming years, both the cost of debt will increase while, at the same time, the absolute level of outstanding debt will also increase. Not a good combination. How this gets resolved is unclear, but we know the trajectory is unsustainable.

Equity Update

We continue to hold a portfolio of what we believe to be high-quality, well-run, durable, and market-leading companies. Irrespective of how the economy performs in the coming years, we expect these companies that we hold to perform well in the long term.

As the stock market moved higher in the first half of the year, we continued to reduce position sizing in technology-related holdings as they reached what we believe are stretched valuations. We utilized a portion of the cash to add to non-technology holdings that had not participated in the market rally.

In our Q1 letter, we addressed the AI hype cycle. In late June, the trend reversed, and many AI stocks saw price declines of 15-20%. We're actively looking for opportunities in companies we believe will be long-term winners and have reasonable valuations.

As we stated last quarter, if the equity markets weaken in the coming months, you should expect us to add to existing holdings and new positions to the equity portfolio.

Fixed Income Update

We continue to see fixed income as an attractive investment destination. With higher interest rates, we're seeing attractive fixed income return opportunities. Our fixed-income portfolio combines high-quality corporate bonds, treasuries, and floating-rate private credit holdings.

Real Estate Update

The impact of higher interest rates continues to cycle through the real estate market. Over one-third of all commercial real estate loans mature in 2024 and 2025. Most of these loans have very low interest rates and will need refinancing at higher rates. Where this scenario exists, there are limited solutions for owners. The choices include raising additional equity (dilutive capital call) or refinancing at higher rates and accepting lower distributions. While this environment is painful for some, we are seeing a growing opportunity to invest capital at attractive rates of return.

We do not believe the anticipated Federal Reserve rate cuts will be enough to avoid the inevitable pain over the horizon.

Private Equity Update

We closed one of our investments in late July, and we are working through a sales process for another one, expecting to close in September. We also have offers for additional real estate holdings. While we are early in the process, should these transactions conclude, we expect to have proceeds late in Q3 2024.

Summary & Firm Updates

To further optimize capital gains taxes in our equity portfolios, we will increase the frequency of our tax loss harvesting trades. Beginning in October and continuing every 4 to 5 months, we will perform more regular tax loss harvesting. We will harvest losses quarterly and more programmatically using our portfolio management software platform, Orion. These efforts will drive additional tax losses to offset current and future capital gains.

In addition, beginning with our Q4 2024 updates, you will notice improved real estate and private equity reporting. Starting in Q4 2024, our clients will see projected income from all real estate holdings and enhanced performance reporting for real estate private equity.

As a firm, we continue to focus on the road ahead and have a constant eye towards long-term planning and preparation. We are grateful for your trust and relationship, and the team at Carmel is working hard each day to navigate the ever-evolving geo/political climate.

We hope you found this brief valuable, and we encourage you to share it with your fellow investors. For further discussion or personalized advisory, please reach out to info@carmelcap.com, 858-457-7544, or visit our Contact Page.

About the Founder

Russell Silberstein

Prior to forming Carmel Capital Partners in 2002, Russell was a managing partner at Bedell Investment Counseling, LLC, a San Francisco Bay Area firm with $120 million in assets under management. He held the position of Director of Research & Portfolio Manager from 1996 to May 2001 at Bedell Investment Counseling, LLC. He was also the managing partner of the Harmony Fund, LP, a long/short investment fund. Russell graduated from San Diego State University.

About Carmel Capital Partners

Carmel Capital Partners was founded in 2002 by Russell Silberstein with the goal of delivering stable long-term returns to individuals, families, and entrepreneurs through opportunistic, value-oriented investments. The firm serves individuals, families, and entrepreneurs across California and manages approximately $333m in assets as of May 2024.