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**ELM RIDGE**

# *"Propellerheads"*

December 31, 2025

*"Graham and Dodd investors are people who place a very high value on having the last laugh. In exchange for the privilege, they have missed out on a lot of laughs in between."*
**– Michael Lewis, *The New New Thing*, 2000.**

This was another good year for the markets. But if you really want to put all your eggs in the all-that has-been-good-will-stay-so-interest-rates-are-coming-down-again-credit-issues-have-not-surfaced-and-will-not basket, you can read this for a few YouTube clips and move on. The S&P has been compounding at about 15% since the end of the 2008 Financial Collapse, the first twelve of those years supported by the Fed and the last three appearing to indicate that we could eventually power through as rates adjusted.

## Green Shoots

*"There will be growth in the spring."*
**–Chauncey Gardner, *Being There*, 1979**[1]

While we're still waiting for a big, concerted move upward in value, there have been enough green shoots to keep our readers afloat. First, some of the hard-hit financials: AerCap (AER); Citigroup (C); and OneMain (OMF) we talked about; began to climb the wall of worry, with an average return of 170% (about 2x the S&P) over the past three years, and yet they still sell at multiples well below their competitors.

Meanwhile, a few of the low-priced industrials we touched on seem to have awakened as well. Alcoa (AA), GM and Mittal Steel (MT) have shrugged off tariff concerns to return more than 60% on average this past year, with another similar sized move needed to get them to our calculations of fair value.

On the other hand, we must acknowledge that Lyondell (LYB), another stock we discussed in our first quarter letter, with an 8% dividend yield, has tumbled such that it now sports a 13% one. We are now in the middle of the longest and deepest polyethylene (plastics[2]) down cycle in modern history,[3] with about a quarter of world capacity at risk of closure. At current levels, we understand that, even with its low-cost position, the company can barely generate enough cash to support its dividend (although it does have a year's worth in the bank) and that the analyst community and most professional investors are pushing management to cut it. While they continue to tout the fact that they have increased the payout for 14 straight years, we think that if they did cut, the stock would most likely rise, since professionals would no longer need to worry about being embarrassed (a sin way worse than leaving

[1] https://www.youtube.com/watch?v=VietO5mmJcI
[2] https://www.youtube.com/watch?v=eaCHH5D74Fs
[3] So says our good friend ChatGPT.

money on the table). Even some of the skeptics admit that, at this price, LYB could return over 30% annually to shareholders over the cycle.

## History Repeating?

*The word is about, there's something evolving,*
*Whatever may come, the world keeps revolving...*
*They say the next big thing is here,*
*That the revolution's near,*
*But to me it seems quite clear*
*That's it's all just a little bit of history repeating.*

*The newspapers shout a new style is growing,*
*But it don't know if it's coming or going,*
*There is fashion, there is fad*
*Some is good, some is bad*
*And the joke rather sad,*
*That it's all just a little bit of History repeating.*
**–Propellerheads, 1997**[4]

*"Lengthy, uninterrupted booms, like the one in the 1920s, produce a collective delusion. Optimism becomes a drug, or a religion, or some combination of both. Propelled along by a culture of hot tips, one-of-a-kind deals, killer sales pitches, and irresistible slogans, people lose their ability to calculate risk and distinguish between good ideas and bad ones."*
**-Andrew Ross Sorkin**[5]

*"The only thing new in the world is the history you don't know."*
**-Harry Truman**

Recent performance is just a sideshow. We're looking for regime change, as prolonged supranormal returns in credit sensitive assets (growth stocks, debt, housing and "alternatives[6]") sew the seeds of its undoing. As Howard Marks argues in a recent memo, "Cockroaches in the Coal Mine"[7] (a worthwhile read for anyone interested in investing):

> The key observation is that good times lead to complacency, risk tolerance and carelessness, as people bid aggressively for assets and compete to make loans. And then the bad times expose the results of that carelessness, as investments that were entered into without an adequate investigation and margin for error fail to hold up in a hostile environment.

The tidal wave of funds thrown at alternative managers has left a situation where it is now estimated that the "unregulated shadow banking system" controls $70 trillion, with 50% of financial assets touched by unregulated entities – as one observer noted in pointing to the paralleled growth of the trust banks into the Panic of 1907.[8] These sums have to bid up asset prices and facilitate more risk. While we acknowledge Marks' admonition that the

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[4] https://www.youtube.com/watch?v=nC2pgcagyRk&list=RDnC2pgcagyRk&start_radio=1

[5] *1929: Inside the Greatest Crash in Wall Street History--and How It Shattered a Nation,* Andrew Ross Sorkin.

[6] Typically a more levered but illiquid version of the preceding.

[7] https://www.oaktreecapital.com/insights/memo/cockroaches-in-the-coal-mine

[8] "Marc Rubinstein on the Hidden Fault Lines in Modern Finance", *Institutional Investor*, 12/16/25.

recent string of troubling news in credit land (e.g., some high-profile defaults and frauds) need not portend any new systemic problem, we agree that the current starting point should make any investor leery.

So you can ignore the ***Financial Times*** (12/30/25) headline "Private equity firms sell assets to themselves at a record rate" (while also selling minority stakes at unprecedented levels.[9]) Don't worry about the Financial Stability Board and IMF's concerns about the quality of Private Credit – now comprising more than 1/3 of North American insurance company investment portfolios.[10] While reported loan default rates are still low, S&P now monitors the growing number of "selective defaults" where loans are "cured" by adding interest to the value of the loan (so called Payment-in-Kind, or PIK loans) in lieu of cash payments, with the adjusted default rate now up to 4.6%.[11] So what if the share of private credit loans sporting PIK features, has quadrupled to nearly 20% over the last three years[12] and Goldman Sachs Asset Management estimates that 15% of private credit borrowers aren't generating enough operating cash to cover interest costs.[13]

We think the supportive landscape for credit and all things risky has helped fuel for the market's love affair with AI and other growth (e.g. "compounder") stocks. But the AI story would have engendered excesses all by its lonesome. To quote Marks again:

> There's a consistent history of transformational technologies, generating excessive enthusiasm and investment, resulting in more infrastructure than is needed and asset prices that prove to have been too high. The excesses accelerate the adoption of the technology in a way that wouldn't occur in their absence. The common word for these excesses is "bubbles." [14]

One AI start-up just raised a mere $2b at a $10b valuation (and just a couple of months later is looking at a $50b number), and yet the company has not released a product nor told its investors what it is trying to build. Said one investor (who we gather still ponied up some dough) "it was the most absurd pitch meeting, … we're doing an AI company with the best AI people, but we can't answer any questions."[15] We get it. "I could I tell you, but then I'd I have to kill you."[16] When Nvidia reportedly agreed to spend $20b (or 40x forecasted revenue) for privately held Groq, Sheetal noted that "it's only $20b." Of course, that makes Groq worth way more than both LYB and OMF, who pay their shareholders more in dividends than Groq has sales.

We all should be grateful for the legions of investors who ended up losing their shirts supporting the initial frantic buildouts of railroad, radio, and internet infrastructure – before subsequent generations built profitable businesses with that scaffolding. We don't doubt that, in due time, AI has the potential to provide a huge boon to economic output. I hope to live long enough to give thanks to those now chasing the dream, who will have so selflessly sacrificed their wealth in support of what promises to be another game-changing technology.

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[9] ***Wall Street Journal***, 12/24/25.

[10] ***Bloomberg News***, 12/19/25 ***and Institutional Investor***, 11/21/25. The FSB is an international organization formed in 2009 to monitor the global financial system

[11] "Private Credit Hysteria Will Get Very Real Soon," Paul J. Davies, ***Bloomberg Opinion***, 12/1/25.

[12] JP Morgan, 11/25/25.

[13] "Investment Outlook 2026" Goldman Sachs Asset Management.

[14] https://www.oaktreecapital.com/insights/memo/is-it-a-bubble

[15] https://www.derekthompson.org/p/this-is-how-the-ai-bubble-will-pop

[16] https://www.youtube.com/shorts/Bu4BH-V10Yk

So it need not concern us that while GPU chips are reportedly in shortage, compute prices have fallen by a third since April.[17] Circular deals in the AI world (I'll invest or agree to back X hundreds of billions of your AI build out in return for a commensurate purchase of my chips or services, thereby creating revenue out of thin air) have become so commonplace that no one bats an eyelash. We should cheer those investors and tech companies willing to throw billions at anything AI since a mere mention of it is likely to send their stocks and holdings higher. Isn't it nice that a couple of private credit lenders report that borrowers are now asking for more than 100% of the build out cost for new data centers.[18] But commitments are now soaring to such a degree that players are once again forced to turn to special purpose financing vehicles (SPVs, designed to keep debt off balance sheets), that helped hide risk in 2008 – as Meta just did with its proposed new data center.[19]

We'll defer to Marks one more time:

> **While the parallels to past bubbles are inescapable, believers in the technology will argue that "this time is different."** Those four words are heard in virtually every bubble… On the other hand, Sir John Templeton, who in 1987 drew my attention to those four words, was quick to point out that 20% of the time things really are different. **But on the third hand, it must be borne in mind that behavior based on the belief that it's different is what causes it <u>not</u> to be different**! (his emphasis).
>
> …AI is currently the subject of great enthusiasm. If that enthusiasm doesn't produce a bubble conforming to the historical pattern, that will be a first. [20]

You can read history or watch South Park's "Margaritaville."[21] Your call.

We recognize that none of the above need spell game over – and if it did, the game would have already ended. But it is interesting that both Apollo and Nvidia felt sufficient pressure to publish detailed rebuttals to some of the most visible critiques. At first blush, their responses do sound convincing. For example: public credit is also illiquid; insurance companies list their individual investments but banks don't; levered lending has recorded limited loss rates over the past 15 years; NVDA's cash *payments* to customers have been insignificant; NVDA customers may be losing money but they are pursuing a great opportunity; and the fact that 5-year old chips are still running indicates that they are depreciating them correctly. But they are attacking straw men. We accept that levered lending ought to perform well in an era of benign credit. While public credit may have its issues, the fact that a $2b loan marked was marked by Blackstone, Apollo and KKR at 82, 77 and 91 respectively[22] doesn't instill confidence in the private kind. Our issue with NVDA is with its commitments, not what it has paid out thus far. And the fact that 5-year-old GPUs are still running doesn't mean that they are worth more than a smidge of what they originally cost.

We do recognize that a severe market dislocation would take low-priced stocks with… at first. But the investors who've taken a pass on cyclicals have been fearing a possible upcoming recession for almost all the past 15 years. We too are wary and are looking for those companies with the balance sheet and low-cost position to weather any hit from decreased demand – and can thus take advantage of any temporary dips to buy back even more of their overlooked shares. If the buy-growth-at-any-price strategy does falter, investors would probably once again look to real cash-generating support that ultimately underpins stock prices as was the case in 2000 and 2022.

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[17] "How much does AI rhyme with Shale," ***<u>The Carlyle Compass</u>***, 11/25/25.

[18] ***<u>Bloomberg News</u>***, "AI Data Center Boom Sparks Fears of Glut Amid Lending Frenzy," 12/12/25

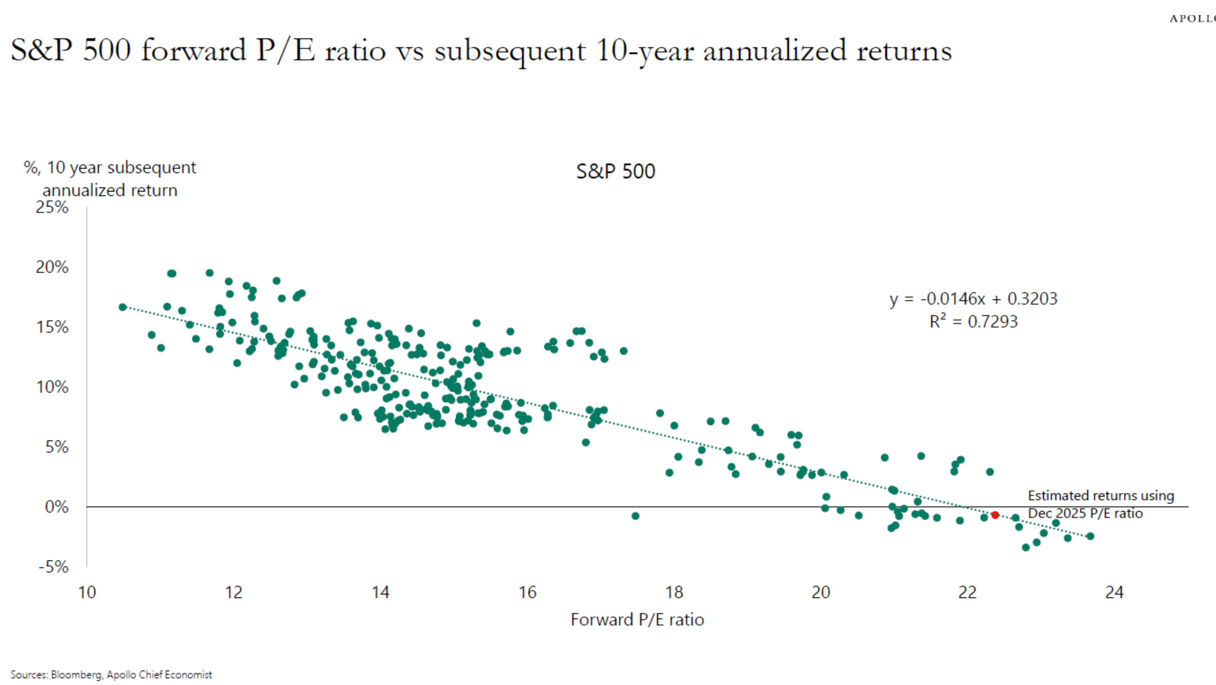
[19] " Meta Announces Joint Venture with Funds Managed by Blue Owl Capital to Develop Hyperion Data Center" press release 10/21/25.

[20] Oaktree, "Is it a bubble?" Op Cit.

[21] https://www.youtube.com/watch?v=2Yrr0Or8O-E and https://www.youtube.com/watch?v=OtpwAg0KTeA

[22] ***<u>Bloomberg News</u>***, 11/13/25

While we're finally seeing some shots across the bow of the Good Times Supertanker,[23] it could well hold its course for some time. True, there is **no record of positive returns over the following 10 -years** when the S&P's P/E has reached current levels (see chart on the next page), but there could always be a first. That's not a bet we would want to take. Cue up the Propellerheads.

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[23] From Abby Cohen's famous 1998 contention that the United States market and economy is "like a supertanker. We're not the fastest ship. We're not the prettiest ship. But it's very hard to knock us off course."

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