SMEAD capital management

Pulling The Punch Bowl

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Pulling The Punch Bowl

Dear fellow investors,

Overall common stock index performance can be a very confusing thing to most investors. From a cyclical standpoint, the history of stock price performance in the U.S. is closely associated with the Federal Reserve Board. When the Federal Reserve Board reverses an accommodative interest rate policy, it is affectionately referred to as "pulling the punch bowl." Why do stock prices fluctuate with monetary policy and where are we in that cycle? Did the Federal Reserve Board Chairman, Jerome Powell, just "pull the punch bowl" on November 29, 2021?

As a preface to this discussion, we will share two points. First, the value of a bond fluctuates up and down based on the prevailing interest rate (one of the toughest concepts taught in college economics classes). Second, stock index price performance does not correlate with economic growth. This is a source of great frustration to most investors. Here is how Warren Buffett explained this in 1999:[1]

> *DOW JONES INDUSTRIAL AVERAGE Dec. 31, 1964: 874.12 Dec. 31, 1981: 875.00*
>
> *Now I'm known as a long-term investor and a patient guy, but that is not my idea of a big move.*
>
> *And here's a major and very opposite fact: During that same 17 years, the GDP of the U.S.--that is, the business being done in this country--almost quintupled, rising by 370%. [...] And yet the Dow went exactly nowhere*

To understand the opposite scenario, here is how he explained 1981-1998 by beginning in 1981:

> *And as is so typical, investors projected out into the future what they were seeing. That's their unshakable habit: looking into the rear-view mirror instead of through the windshield. What they were observing, looking backward, made them very discouraged about the country. They were projecting high interest rates, they were projecting low profits, and they were therefore valuing the Dow at a level that was the same as 17 years earlier, even though GDP had nearly quintupled.*
>
> *Now, what happened in the 17 years beginning with 1982? One thing that didn't happen was comparable growth in GDP: In this second 17-year period, GDP less than tripled. But interest rates began their descent, and after the Volcker effect wore off, profits began to climb--not steadily, but nonetheless with real power. [...]*
>
> *What was at work also, of course, was market psychology. Once a bull market gets under way, and once you reach the point where everybody has made money no matter what system he or she followed, a crowd is attracted into the game that is responding not to interest rates and profits but simply to the fact that it seems a mistake to be out of stocks. In effect, these people superimpose an I-can't-miss-the-party factor on top of the fundamental factors that drive the market. Like Pavlov's dog, these "investors" learn that when the bell rings--in this case, the one that opens the New York Stock Exchange at 9:30 a.m.--they get fed. Through this daily reinforcement, they become convinced that there is a God and that He wants them to get rich.*

Here's what Charlie Munger had to say about today's market circumstances on December 3, 2021:[2]

> *On the broader market, Munger sounded the alarm on sky-high equity valuations and investors' speculative behaviors, saying that the current environment was "more extreme" than anything he had ever experienced.*
>
> *The stock market has bounced back swiftly from the pandemic-induced bear market. The massive comeback attracted a record number of amateur investors who at times bid up speculative stocks in manic momentum-driven trading.*
>
> *The dot-com boom was crazier on the valuations even than we have now but overall, I consider this era even crazier than the dot-com era. You have to pay a great deal for good companies and that reduces your future returns.*

To reiterate Buffett's thoughts, bull markets in stocks take on a party atmosphere. Just witness the goofy level of option trading, the millions of small investors chasing exciting futuristic companies/meme stocks and the undying devotion to index investing. What is the connection between that party atmosphere and Federal Reserve policies?

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Theory

When the economic growth and activity are below average, like in 1982, the Federal Reserve uses "easy" money policies. These policies include increasing the money supply via open market purchases of bonds and reducing interest rates at which member banks borrow from the Federal Reserve. In theory, this is done to encourage economic activity. From a practical standpoint, it usually causes investors to move money from interest-bearing securities into common stock ownership. The money almost never gets put straight into the business world, because there is extremely negative sentiment for business at the time the Fed acts, just like in 1982.

For this reason, the best percentage stock market rallies of my career were in 1982, 1991, 2009 and 2020-2021. In all cases, the Fed's easy money policy got dumped into bonds and common stocks, triggering big bull moves. Notice the Fed funds rate came way down from the highs:

Chart of August 10, 1982 – August 9, 1983:

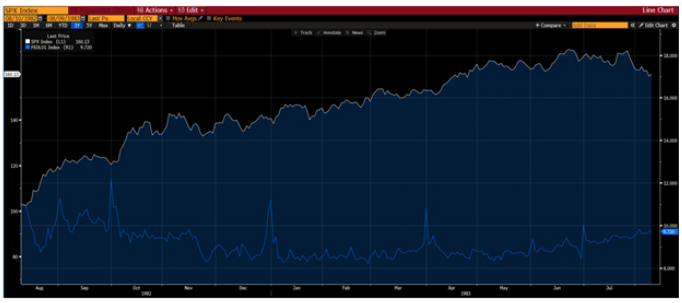

Chart of January 7, 1991 – January 14, 1992:

Chart of March 10, 2009 – March 10, 2010, 1992:

Chart of March 16, 2020 – March 15, 2021:

The exact opposite is true when the Fed tightens credit to slow down an overheated economy or to stop the inflation wolverine from roaming the landscape! Let's look at when the Fed pulled the punch bowl:

- 1981-1982: The S&P 500 Index fell from 140 to 112 as a cheap market got way cheaper.
- 1987: The S&P 500 Index fell 41% in 78 days after the Fed tightened credit to slow merger mania.
- 2000-2003: The S&P 500 Index fell 47.2% after the tightening to slow down the Dotcom Bubble.
- 2007-2009: The S&P 500 Index fell 54% after the tightening designed to slow down the real estate mania of 2004-2006.

The thing to understand about our current circumstance is that is has come 40 years into the most pervasive and extended "easy" money period in U.S. history. This has led to 40 years of declining interest rates (did we mention $4-5 trillion of U.S. government borrowing to fight the pandemic?). This means that investments from bonds to equities with long duration attached are filled with the most long-term confidence of the last 40 years. **What a powerful "rearview mirror!"**

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Great investments start from zero confidence and grow via increasingly high levels of confidence. For this reason, owners of "two in the bush" stocks are running the highest risk possible. When the punch bowl gets pulled, the margin of safety in stocks goes to the "bird in the hand." You can almost hear Janet Jackson singing, "What have you done for me lately, Ooh, Ooh, Ooh."

Rather than looking through the "rearview mirror," let's look ahead. What investments do well when the Fed is tightening credit and fighting inflation? Go back to the decade of the 1970s, which was spent fighting inflation. Energy stocks, real estate and home building thrived, because they were viewed as beneficiaries of the inflation. Fear stock market failure.

Warm regards,

Bill Smead
Chief Investment Officer

[1] *Fortune*, "Mr. Buffett on the Stock Market (Fortune, 1999)" (https://fortune.com/1999/11/22/warren-buffett-on-stock-market/#:~:text=Now%20I'm%20known%20as,idea%20of%20a%20big%20move.&text=The%20basic%20proposition%20is%20this,the%20risk%2Dfree%20interest%20rate.)

[2] *CNBC*, "Charlie Munger says Costco will eventually be a huge internet player, posing a big threat to Amazon" (https://www.cnbc.com/2021/12/03/charlie-munger-says-costco-will-eventually-be-a-huge-internet-player.html?&qsearchterm=charlie%20munger)

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