SMEAD capital management

Newsletter

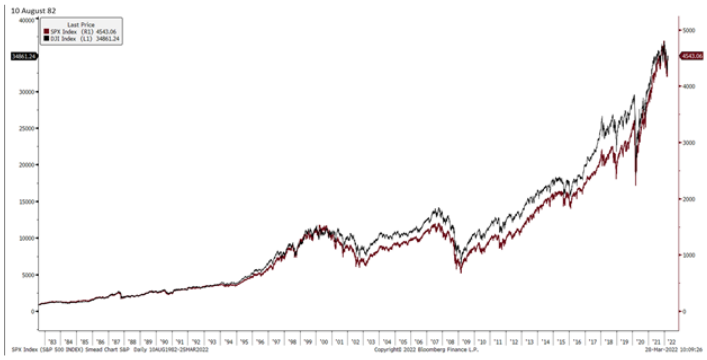
SMEAD US VALUE — 1ST QUARTER 2022 (3/31/2022)

The Twilight Zone

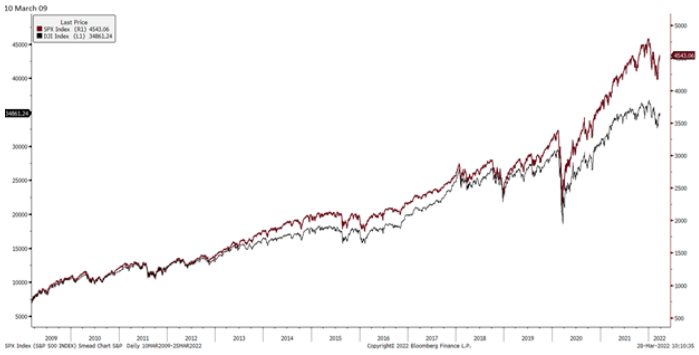
"A situation or state of mind seemingly between reality and fantasy."

Depending on your age, the bull market in stocks started in 1982, with stocks trading at six-times earnings and the U.S. Treasury Bonds paying 15% interest, or in 2009 at the bottom of the financial crisis. Either way, the combination of the Federal Reserve Board's liquidity and the popularity/stock market domination of technology stocks have entered us into what we will call "The Twilight Zone."

Backward-looking returns indicate that these two periods have produced some of the most spectacular successes of the last 100 years:

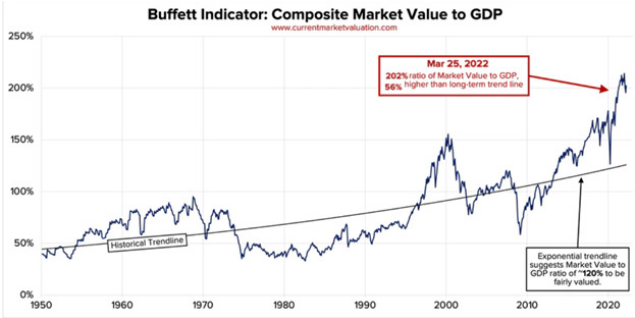


Source: Bloomberg. Data for the time period 8/10/1982 - 3/31/2022.

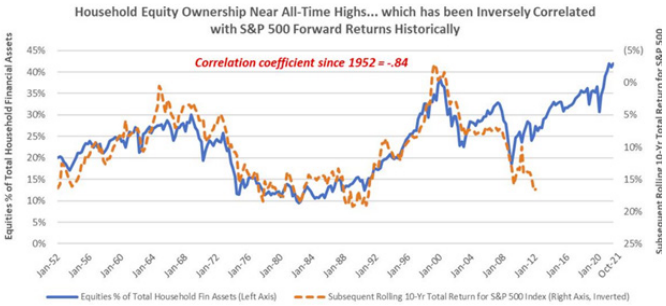


Source: Bloomberg. Data for the time period 3/10/2009 - 3/31/2022.

Where does this leave us? First, the U.S. stock market is incredibly expensive from a historical perspective as measured by Warren Buffett's favorite measuring tool, household equity ownership and price-to-earnings (P/E) ratios.



Source: CurrentMarketValuation.com. Data from 1/1/1950 – 6/30/2020.



Source: Federal Reserve Data, Bloomberg. Data from 1/1/1952 – 10/31/2021.

Source: Bloomberg. Data from 12/31/1999 – 12/31/2009.

None of this was a problem until the bond market began to correct and the Fed Chairman, Jerome Powell, recognized that inflation is what we call a "wolverine" and is not "transitory." The four preconditions of the 1970s inflation were the Vietnam War, Johnson's Great Society legislation, the size of the baby boomer demographic group on a relative basis and the Arab Oil Embargo of 1973-1974.

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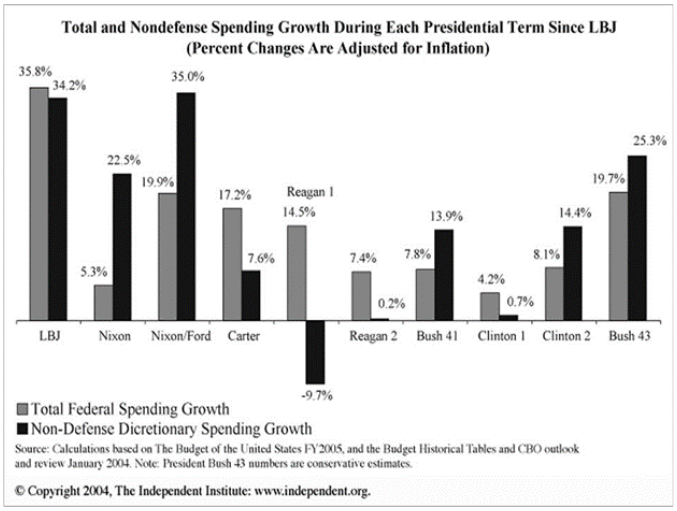
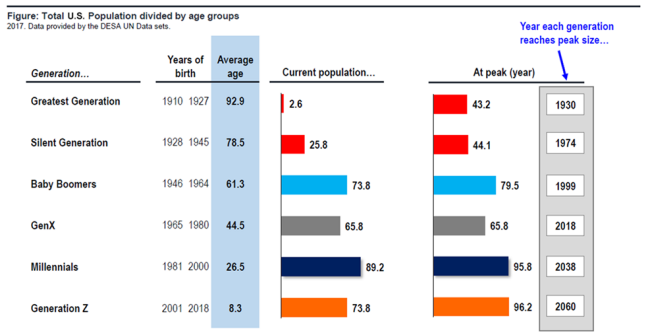
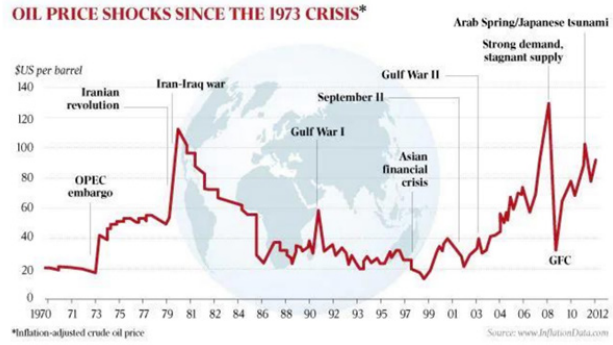


Source: Bloomberg. Bloomberg. Data from 12/31/1928 – 12/31/1938.



Source: Fundstrat.

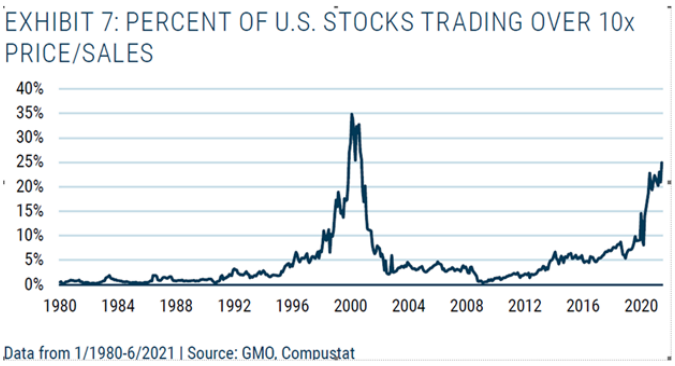


Source: Inflationdata.com. Data from 1/1/1970 – 12/31/2012..

As the sun is possibly setting on the great bull market of the last 40 years, we can just substitute the Pandemic War, the Trump-Biden Federal Government spending to combat the lockdowns, the size of the Millennial demographic relative to Gen X and the Arab Spring castration of U.S. oil production in 2020 to hear the "rhyme!"

Warren Buffett and Charlie Munger have said many great things in our time in the stock-picking business. Buffett has explained recently that interest rates serve as a form of "investment gravity." He argued that low interest rates elevate stock prices and the move from 1982 to today has been more about higher stock prices via gravity. Economic growth was much higher from 1964-1981 than it was from either 1981-1999 or 2009-2019. They also have argued the Aesop was the guy who started investment logic when he said, "A bird in the hand is worth two in the bush."

We are in The Twilight Zone of this bull market because the bond market is dragging the P/E ratios of "two in the bush" companies down. The chart below shows how dominant the "two in the bush" stocks were in the S&P 500 Index:



Source: GMO, Compustat. Data from 1/1980 – 6/2021.

We are also in the Twilight Zone with the world's largest capitalization companies. At the end of each decade, here were the ten largest, including how they did over the next ten years:

Largest Companies Globally by Market Cap

	1980		1990		2000		2010		2020	
Rank	Company	10-Yr Fwd Return	Company	10-Yr Fwd Return	Company	10-Yr Fwd Return	Company	10-Yr Fwd Return	Company	10-Yr Fwd Return
1	IBM	10%	Nippon Telegraph &	-1%	Microsoft	5%	PetroChina	-10%	Apple	?
2	AT&T	16%	Bank of Tokyo-Mitsubishi	-5%	General Electric	-6%	Exxon Mobil	-2%	Saudi Aramco	?
3	Exxon	18%	Industrial Bank of Japan (1)	-12%	NTT DoCoMo	-8%	Microsoft	26%	Microsoft	?
4	Standard Oil	10%	Sumitomo Mitsui Banking	-5%	Cisco	-6%	ICBC	4%	Amazon	?
5	Schlumberger	0%	Toyota Motors	10%	Walmart	2%	Walmart	13%	Alphabet	?
6	Shell	16%	Fuji Bank (1)	-10%	Intel	-2%	China Construction	4%	Facebook	?
7	Mobil	11%	Dai-ichi Kangyo Bank (1)	-8%	Nippon Telegraph &	-6%	BHP Billiton	3%	Tencent	?
8	Atlantic Richfield	13%	IBM	14%	Exxon Mobile	8%	HSBC	-1%	Tesla	?
9	General Electric	18%	UFJ Bank	-8%	Lucent	-28%	Petrobras	1%	Alibaba	?
10	Eastman Kodak	8%	Exxon	17%	Deutsche Telekom	-7%	Apple	30%	Berkshire Hathaway	?
	Top 10	12%	Top 10 Average	-1%	Top 10 Average	-5%	Top 10 Average	7%		
	S&P 500	14%	S&P 500	17%	S&P 500	1%	S&P 500	14%		

Source: @CharlieBiello, Bloomberg
(1) Return for Industrial Bank of Japan, Fuji Bank and Dai-ichi Kangyo Bank is 12/31/1990 to 9/21/2000 (on 9/21/2000, these three banks merged to create Mizuho Financial Group).

Despite having Buffett's gravitational tailwind behind their P/E ratios, these lists underperformed the index four out of four times and lost money over the following ten years 50% of the time. Are those odds that you want stacked against you going forward?

Now that you understand what investments are in the twilight of their bull market, let's talk about what investments do well when bond rates rise, and inflation expectations get intertwined with stock market capitalizations. In other words, what investments could be just seeing the sunrise.

Commodities started a bull market in mid-2020 that we believe may have legs for at least a decade. Oil stocks were at the core of

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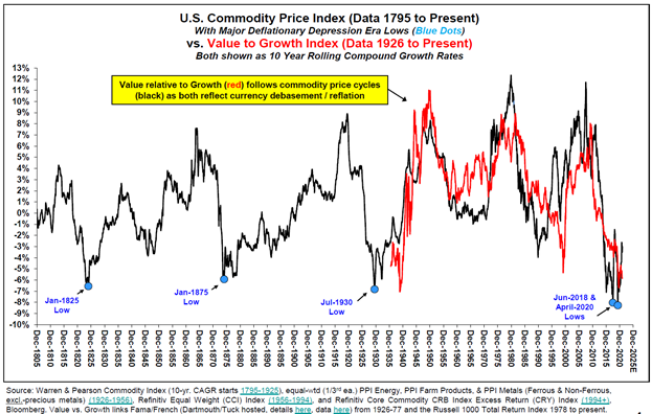
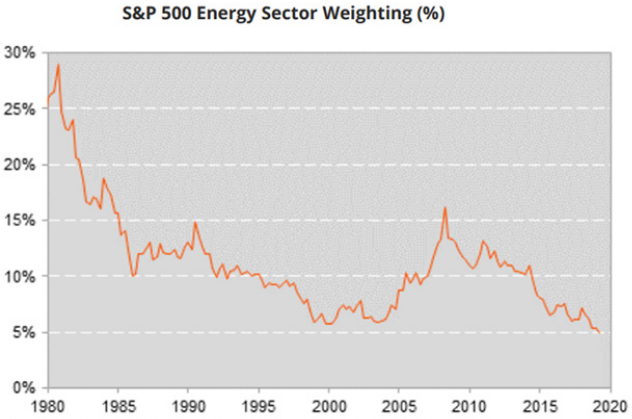
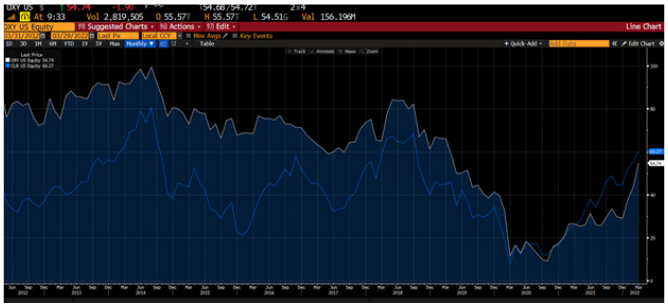
the inflationary momentum popularity in the 1970s and dwarfed the representation in the S&P 500 Index when inflation mattered the most in 1981:





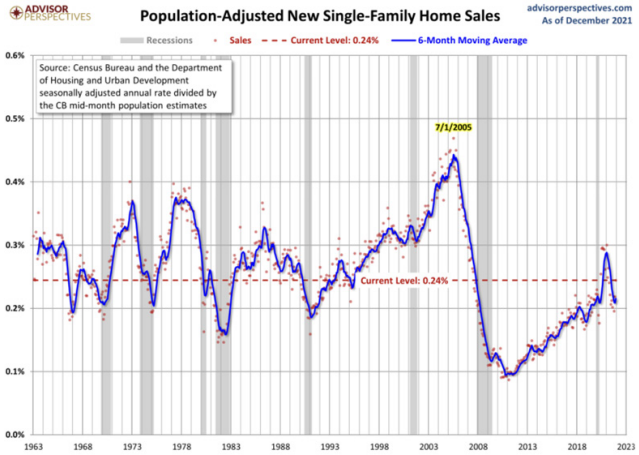
Energy sector share of the S&P 500 index by quarter from 1979 to 2019.
Source: PKVerleger

Our oil stocks, Occidental Petroleum (OXY) and Continental Resources (CLR), are lagging way behind the prevailing oil prices compared to 2014:



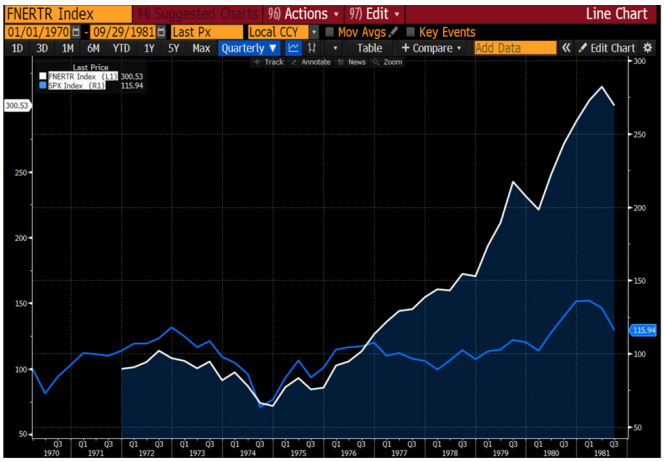
Source: Bloomberg. Data for the time period 3/31/2021 - 3/31/2022.

Houses are under-built, and we believe our home builders (DHI, LEN and NVR) have scale and very strong balance sheets to meet the economic need:



Source: Advisor Perspectives. Data for the time period 1/1/1963 - 3/31/2022.

REIT Class "A" malls get inflationary rent expansion via revenue sharing above base minimum rent and were good inflation beneficiaries in the 1970s.



Source: Bloomberg. Data for the time period 1/1/1970 - 9/29/1981..

Therefore, the question for investors is, do you want to squeeze blood out of a "Twilight Zone" turnip in the S&P 500 Index? Do you want to pick for a needle in the haystack among the vast cadre of growth stock investment choices? Or do you want to enjoy the potential sunrise stage in stocks that have historically gained popularity as investors chase "the bird in the hand" in more inflationary times?

Fear stock market failure!

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Chief Investment Officer

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